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THE PERSONAL WEALTH COACH®

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TPWC Market and Economic Update

The Markets

The S&P 500 closed out last week at 2080.73, and today it closed at 2091.58, up just over half a percent. That makes the Index up about 15.55% from where it was in mid-February, but still down about 2% from its high last May. The Dow Jones Industrial Average did manage to make some news as it closed at 18,003.75, finally rising above the psychologically important 18,000 level! Despite the fact that big, round numbers like that are objectively no more important than any other number, research has suggested that investors consider them significant. In the case of the Dow, crossing thousand-levels may be a marker for what follows. Time will tell, but we are optimistic.

Bonds continued a sell-off that started last week with the U.S. benchmark 10-year U.S. Treasury note now yielding 1.88%. To put that in perspective, the yield has varied from a high of 2.49% last June to 1.64% in mid-February. The yield has risen about the same relative percentage as the S&P 500 Index over the same period. Critically, the value of the underlying note on the open market falls as the rate rises. The historically normal behavior of Treasury notes falling largely in sync with stocks rising appears to be reasserting itself.

Euro-based bonds continue to decline to even more pronounced negative rates as do those of Japan. The markets may be returning to something like historical rationality here in the United States, but the Mad Hatter seems to still be having his tea party in much of the rest of the world.

The Economy

A lot is going on in the world economy, but there almost always is a lot happening there. Greece is once again teetering on the edge of default, as is Puerto Rico; U.S. employment continues to rise; oil appears to be reaching an equilibrium in supply and demand, and the Chinese economy seems to be in better shape than many people expected. Public opinion in Great Britain appears to be shifting against exiting the European Union. The front-runners for the Presidential nomination races look to be pulling ahead. The European Central Bank announced that it will reduce the already negative interest rates in Europe. Venezuela appears to be headed for economic collapse. There seems to always be something to be frightened about, particularly if we are in a long-term bull market. Bull markets climb a wall of worry.

Possibly the most notable thing is that events that generated scary headlines months or years ago, like Greece's looming default, are hardly noticed today. The things that we collectively seemed to fear only a short while ago are no longer newsworthy, even if they are more likely today than they were when they caused the markets to plunge! What we have seen is that the U.S. economy is a heck of a lot stronger, and more resilient than the pundits or the political candidates appear to have believed. That does not mean the fear has gone away.

In our opinion, the most important economic news this week was a report on investment cash flow.

Investor Behavior

Investor behavior is one of the most consistent indicators of what is happening and what is likely to occur in the future regarding the markets. Despite a quite impressive rally in U.S. equity markets, investors pulled $7.3 billion dollars out of equity funds in the week ending Wednesday. $4.2 billion of that was from U.S. equity funds.

Mutual fund money flows are historically reliable indicators of where amateur, emotionally driven investors are moving their money. Studies have repeatedly demonstrated that the flows of emotionally-driven money, often in company-provided retirement accounts like 401(k) plans, is what professionals call a "contrarian indicator." Such signs are a relatively reliable guide to what not to do. Wherever the herd is stampeding is unlikely to be a good place to be. Conversely, it is often from whatever the crowd is fleeing where investors are likely to find the best opportunities.

One critical question then is, "Where is the money going?" It appears that much of the billions of dollars investors have taken from equity funds have gone to bond funds. The irony is that this flow from equities to bonds coincides with a growing consensus among economists that interest rates will rise later this year. When interest rates rise, and note I wrote "when" not "if," the value of those bond funds will fall. If history is any guide, they may fall a lot.

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A second destination for the cash flow investors are taking from stock funds is a relatively ill-defined set of investments called, "alternatives." Again a bit of irony arises in that Blackstone's Senfina Hedge Fund one of the larger, "bellwether" alternative investment funds just reported that it lost 15% in the first quarter. Blackstone, the largest alternative investment manager in the world, reported an 85% drop in net earnings for the quarter. Despite acknowledging across the board investment losses, Blackstone reported an 11% increase in investment assets. Blackstone had billions of dollars of newly invested money coming in even as the alternative funds (alts) it hailed as the "new stars" of the investing world had substantial losses.

Investing in an asset class that is "down" is often a good strategy, but for that to be successful, the presumption is that the underlying proposition of the class must be sound. The proposition of alternative investments is that they will protect from losses in down markets, or they will provide higher income in a low rate environment, and do so without undue risk. People appear to have bought into Senfina because it promised a high return when the markets were not providing that performance and rose about 20% in 2015. Of course, it was not until after most of that appreciation was reported that the money poured in. As a result, many investors in the Blackstone fund got very little of the gain last year, but this year have experienced the full loss. Even the investors that got the 20% increase last year saw their profits wiped out by the losses this year. A 15% loss wipes out a 20% gain! Notably, the fund charges 2% per year on assets plus 20% of profits, so over the last 15 months, investors paid Senfina 7% in fees, which the fund takes from the reported returns, leaving the early investors only down about that much.

If the proposition of a fund such as Senfina is that because of its nature, it will protect against market declines, buying it would seem to us to be a poor choice, but that appears to have not slowed investors fleeing equity mutual funds. If those same investors decide to liquidate, they may find that the promised liquidity of the alternative investments they purchased may not be as high as they hoped.

The lesson we can learn is that it is primarily publically traded equities (stocks) which over the long term have produced the investment gains we need in a portfolio. The price we pay for that opportunity for gain is patience. We 21st-century humans tend not to have a lot of that. In our portfolio reviews, we have heard many variants of "The long-term results look great, but the last few years have been miserable. Isn't there something we can do about that?" Our very consistent answer is, "No."

The price we pay for those long-term gains is, again, patience. Warren Buffet often waits years and sometimes decades for his very successful investments to produce the return for which he is famous. It is the very essence of investment success. Six things have worked and worked well in investing over the long-term

1. Carefully research before investing.
2. Use the science of Investment Theory to choose asset classes.
3. Diversify across asset classes and widely diversify by underlying security.
4. Completely avoid the risk of someone else's financial failure wiping out your investments.
5. Expect unplanned, unpleasant things will happen and generally, at the worst possible time.
6. Find the lowest cost way to do all of that effectively.

Consistently and patiently holding to those principles has demonstrated itself to be the most effective long-term investment strategy for anyone, whether it be Warren Buffet or a worker investing in a retirement plan. Unless an investor has a lot of time, education, and experience, in many cases hiring a professional is another good idea. One more principle then is to hire a professional firm who has that time, education, experience, and critically, a willingness to perform as a fiduciary, operating solely in your best interest.

We don't know when the markets will recognize that things are not falling apart and we have a bright and prosperous future, but we do have confidence that they will. The question is who will still be there to benefit from that recognition.

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