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Ignoring the Crowd

Difficult markets call for us to revisit our investment strategies, take inventory of our emotions, and acknowledge the interplay between the two. This memo will primarily focus on investor psychology and the market cycle. I will follow up in short order with a more specific memo detailing the current market environment and the many steps that led to it. However, I will preface the two memos by saying this first one is far more important because of its universal applicability going forward while the next memo will focus on how we got here.

At the present there is an endless amount of content you could consume either on television or in opinion pieces surrounding:

- The outlook for inflation
- How far will the Federal Reserve raise interest rates
- If a soft landing is possible and if not, how deep will the recession be

Pick a channel, pick a newspaper, or pick a social media post and you can listen to or read endless opinions from prognosticators and talking heads regarding their opinion on these subjects and what the implications are for investors. It would be a failure on my part if I become just another voice in the crowd. This doesn't mean I don't have opinions on each of these topics as I frequently give my opinion during one on one conversations with clients. It is important for me to help clients sift through the noise, parcel out the relevant factors, and enhance your financial knowledge by explaining economic concepts and teaching basic investment principles. I want to be clear, my value to clients is not in my ability to predict how the market will perform over the next six months. My value is in developing long term investment strategies that align with a client's individual needs and encouraging them to stick with that strategy during times when their natural instincts would tell them to do otherwise.

All discussions surrounding inflation, interest rates, and recession fall under the same category: the short term. And yet:

- We can't know with any degree of confidence what the short-term future will bring:
  - Recent forecasts from the "experts" during the past year are evidence of this:
    - Inflation will be transitory – Jerome Powell[1]
    - One 0.25% rate hike by the Federal Reserve in 2022[2]

[1] https://www.reuters.com/business/why-fed-chair-powell-still-thinks-high-inflation-is-temporary-2021-08-27/
[2] https://www.ft.com/content/0a7a4edd-b656-4d6a-b608-454241d0288e

        - No recession in 2022 or 2023 – International Monetary Fund [3]
- Because we can't know with any material degree of confidence what will happen we should not alter our investment strategy materially in favor of one outcome over another because:
    - We aren't traders who base investment decisions on the short term. We are investors who deploy money for the long term.

In the short term, the "investment herd" tends to drive markets one way or the other with an echo chamber driving markets to extreme highs and lows. Bull markets are created by buyers significantly out numbering sellers, which drives up prices, which attracts more buyers to a rising market until the purchasing power of buyers has run out. Bear markets are the opposite. Sellers are more motivated to sell than buyers are to buy which pushes prices down and creates a feedback loop that encourages more selling until the prices reach a point where no one wants to sell.

At these buying or selling extremes the predominant narrative for the herd is strikingly similar: no one can see how or when it might end. In a bear market, no scenario is too negative to be believable and any scenario incorporating optimism is dismissed as wishful thinking. In a bull market everything is wonderful, things will only get better, and anyone who expresses skepticism is just the proverbial Eeyore in the room. These narratives become more powerful at the extremes because by definition the size of the crowd is larger at the extreme. If you believe the narrative everyone else believes, you'll do what they do which is typically buy high and sell low. The takeaway from this fact is that at the extremes, most people are wrong.

It is important to understand that being right about future events by itself is not enough to build a successful short term investment strategy. You must also correctly determine whether the market has mispriced that event and to what degree. A prognostication that the economy will enter a recession is of no value if the current market being down 25% from the highs has already effectively priced that recession in. Again these are the foils of engaging in trading versus investing.

The widespread error is the behavioral instinct to focus on the short term and extrapolate the events of today into the future. This distracts us from our original endeavor, to buy an ownership interest in quality companies and participate in their long term success. When the herd is focusing on short term events that may or may not matter and ignoring the principles of long term success, we should ignore the impulse to follow and maintain course in pursuit of long term investment objectives.

This is not only true for investors in their 30's but those in their 70's as well. The ratio between stocks and bonds will likely differ between the two but both will hold securities that fluctuate in value based on the decisions of the herd. Many retirees are concerned that their timeline isn't long enough to see the recovery. The current drop in the market is the 3rd drop of 20% or more in the past 5 years. See the table on the following page:

[3] https://www.bloomberg.com/news/articles/2022-06-24/us-economy-to-narrowly-avoid-recession-in-2022-23-imf-says?leadSource=uverify%20wall

Date of Market Correction	Market High	Market Low	Percentage Drop
10/03/18 – 12/26/18	26,951	21,712	19.5%
2/12/20 – 3/23/20	29,568	18,214	38%
1/5/22 – 9/30/22	36,952	28,716	22%

During these 5 years we have experienced:

- Federal Reserve rate hikes in 2018
- Global Pandemic
- Contentious Presidential Election
- Start of a new large scale military conflict between Russia and Ukraine

Despite several turbulent years, today's low is still higher than the market highs of 5 years ago. It is prudent for most investors to have some exposure to long term securities in order to combat inflation. The past year has been a reminder that prices will rise over time and the individual must have some capacity to grow their income to meet rising expenses. The evidence continues to show that holding quality investments through the market cycle remains the best way to capture the positive long term returns historically generated by financial markets.

My next memo will focus on the current market environment, inflation, interest rates, and their effects on stocks, bonds, and real estate.

Sincerely,

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