EDELMAN map managed asset program

August 6, 2014

Dear Client:

In Brief:

- Being long-term investors, we're not worried about the stock market
- We are worried that some people are becoming either anxious or complacent
- Market volatility has been low but don't be fooled into thinking that's common, or that a sudden return to volatility is scary
- Therefore, maintain your diversified portfolio instead and let our rebalancing strategy take advantage of market fluctuations for you

Anxiety or complacency?

We hope you're not feeling either of these emotions. If you are, you might be about to make a mistake with your investments. This Update will show you how to avoid mistakes that recent market events may cause people to make.

To start, let's look at this past Thursday. That day, the Dow Jones Industrial Average fell 317 points, a decline of 1.9%.

I mention this because Thursday was July 31; its market values will be enshrined on the July statement you'll receive in a week or so.

The decline that day could make some people feel anxious – worried that their accounts fell in value and that further losses might occur. Now, you've heard me talk and write often about "recency bias" – the psychological tendency to focus on recent events instead of longer, more important trend lines – and last Thursday offers a classic example of this phenomenon.

Many people will focus on last Thursday's market drop, and when they get their July statements, they'll focus on the month's performance. We don't want you to make that mistake.

If you look only at the stock market's performance in July – and particularly at Thursday's – you could develop an opinion quite different from the one you'd have if you looked more comprehensively.

Here's why. July was the worst July since 2011, and July 31 was the biggest one-day decline since February 3. What the July statement won't say is that we had five months in a row of rising stock prices, and that – despite July's lousy month – the Dow is up 6% from last July.

Still, many people – perhaps you – are wondering if last week's market declines portend further declines. They'll point to the fact that a few companies in the S&P 500 Stock Index recently reported lower earnings, that Argentina has defaulted for the second time in 12 years, and that unrest in Ukraine and Gaza persist.

What these folks are ignoring is the fact that there's a lot of good news, too:

- The U.S. economy grew 4% in the past three months, according to the Federal Reserve;
- Consumer confidence is at a seven-year high, according to the Conference Board;
- The unemployment rate is at a six-year low, according to the Department of Labor, and the number of new applications for unemployment benefits reached an eight and a half-year low. More than 200,000 jobs were created in July – the sixth straight month that employment gains climbed by more than 200,000. (The last time we saw six months in a row of such gains was in the 1990s.);
- Consumer spending was up 2.5% in the second quarter and business investment in structures and equipment was up 5.5% in the second quarter, according to the Commerce Department;
- Spending by state and local governments rose 3% in the past three months, according to Bloomberg;
- Real estate rental vacancies fell 8% and home ownership vacancies fell to the lowest level since the housing crash began in 2007, according to the National Association of Realtors; and
- The auto industry is headed for its biggest year since 2007. General Motors, Ford, Chrysler and Nissan all sold more cars in June than analysts expected, according to Bloomberg.

All this helps explain why corporate profits are at all-time highs. Earnings Per Share of the S&P 500, which were $10 in March 2009, are now $29, as estimated by S&P Dow Jones Indices. Thus, stock prices are up 190% since March 2009 because earnings are up 190%. In other words, the growth in the stock market simply reflects the growth in corporate profits.

Certainly, much more needs to be done to further improve and secure our economy's progress. Unemployment is still too high, housing prices are still too low in many markets, and people continue to struggle with the price of food, energy, education and health care. Our infrastructure remains vulnerable to natural disasters and environmental risk, terrorism is a constant threat, and the downing of the Malaysian airliner and fighting in Gaza have everyone concerned.

Still, none of that portends the demise of the U.S. stock market. Our nation has been battling challenges of great magnitude ever since our founding, and yet we've somehow managed to survive and thrive. So we don't think you should allow today's political, social and economic issues to unduly worry you.

And perhaps you're not worried. Perhaps, instead of feeling anxious, you're fine. In fact, you might be more than fine. You might be feeling complacent.

And that's our other worry.

We are noticing that many people are becoming complacent because stock market volatility has been so low this year (until the last week or so that is). In fact, the S&P 500 went 62 consecutive trading days – that's three calendar months – without a 1% increase or decrease in price. The last time we went three months with such low volatility was in 1995 – nearly 20 years ago!

Until July, the stock market was advancing like Aesop's tortoise: slow and steady. (The streak ended July 17.) **Not only is volatility low, it's been actually moving lower. June's volatility (the amount of change in stock prices from day to day and for the entire month) was lower than March's, and March's was lower than February's.**

Compare this to 2008. In that terrible year, there was a 1% market move in over half of all trading days. October of that year saw 20 of 23 days move more than 1%. (This included six days of a 1% change; four days of a 3% change; three days of a 4%; and one day each of 2%, 5%, 6%, 7%, 9%, 10% and 11% changes in prices.) You remember that awful time. That was volatility.

Today, we're experiencing none of that. No wonder so many investors are complacent. And we are concerned about them.

It's called "the volatility paradox." If you don't realize that a quiet market is unusual, complacency might tempt you to become more aggressive with your investments than you should. That means you might take bigger risks than is appropriate for you – and perhaps even more than you can tolerate. So, we want you to remember that volatility is normal and today's low-volatility market is not.

The solution to both anxiety and complacency is the same: you need a highly diversified portfolio, one appropriate for your needs, goals and risk tolerance. This can't guarantee that you'll never experience a decline in your portfolio, of course, but it's a better investment strategy than the alternative, called portfolio concentration.

Like its name suggests, portfolio concentration means putting all your money into just one type of investment. This can lead to portfolios that are either too conservative or too risky. Say you concentrate your assets into select bank accounts, CDs, T-bills and money market funds. Your rate of return would be near zero – actually, worse than zero, because inflation will erode the value over time. We call that "losing money safely."
Conversely, if low market volatility were to make you feel complacent, you might put all your money into stocks – perhaps just in time for volatility to return. (Remember when the S&P 500 fell 38% in 2008?) We want to help you avoid this risk.

Diversification, therefore, is our answer for you. It offers you the potential for higher returns, yet it can insulate you from the volatility that any one asset class might experience.

So don't let anxiety or complacency cause you to do the wrong thing at the wrong time. Instead, maintain your diversified portfolio and remember that we'll take advantage of any such momentary declines thanks to our strategic daily rebalancing review. Rebalancing helps to reduce your investment risk and improve returns – almost making it seem as if we like volatility so we can take advantage of it.

Two quick final points: First, while you can rest assured that you enjoy global diversification in your EMAP® accounts, you might not have that in accounts you hold outside our firm – such as retirement accounts you hold in 401(k), 403(b), TSP and 457 plans. So please make sure you've arranged for diversification in those accounts as well. And remember that you're welcome to talk with your Edelman advisor about those accounts for guidance, too.

Second, **you can't control the markets, so let's make sure you're focusing on what you can control.** Have you reviewed your estate plan lately? Have you implemented all the insurance recommendations we've provided you? Have you reviewed the beneficiary designations on your retirement accounts and insurance policies? Be sure to talk with us about these and all your financial planning issues, so we can make certain you are doing everything you can to protect yourself and your family.

We will continue to monitor the economy, the financial markets and your portfolio, and we'll keep you informed. As always, please let us know if you have any questions.

Enjoy the rest of the summer!

Regards!

Ric Edelman
Chairman and CEO

Investing strategies, such as asset allocation, diversification, or rebalancing, do not assure or guarantee better performance and cannot eliminate the risk of investment losses. There are no guarantees that a portfolio employing these or any other strategy will outperform a portfolio that does not engage in such strategies.