Manager's Report
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It's Tempting – But Don't Do It!

For those who may not be paying attention, stock markets across the globe have been doing well recently. On a year-to-date (YTD) basis, stocks (as measured by the All Country World Index (MSCI ACWI)), have returned over 20%. Even emerging market equities, which have generally lagged developed markets over the last 5 years, are up about 30% for the year. Since the market "bottomed" in February 2016, the broader indices are up about 50%, including dividends.

It has been common for the media to report that popular indices like the Dow Jones, S&P 500, or even the German DAX have reached all-time highs. Indeed, at Baystate Wealth, more than a few our *Week In Reviews* have been dedicated to these record-breaking milestones.

While we find that investors are enjoying the benefits of a strong market, many are puzzled by how resilient equities have been in the face of what seems to be heightened geopolitical uncertainty ranging from a nuclear North Korea to the tweet *du jour*. It is not too much of a surprise that many investors we talk to are concerned about a dramatic fall in stock prices given that markets are reaching all-time highs despite an abundance of chilling headlines from around the world. Under these circumstances this type of feeling is perfectly reasonable and rational. That said, while the emotions might be a normal reaction, it is our view that there are some actions investors can take that are productive while others are simply not a good idea.

To start the discussion, I will focus on what Baystate Wealth believes is not a good strategy to deal with elevated concerns about the equity market. Specifically, I am referring to "market timing." There is no strict definition of the phrase "market timing.". Some "investors" refer to themselves as market timers and wear it as a badge of honor. On the other hand, other investors (which includes us at Baystate Wealth), use the phrase in a more disparaging manner. Our view is that **market timing is a**

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function of the degree to which a tactical allocation deviates from its strategic allocation or the reason for the change.

A **strategic allocation** is a long-term view of how an investor should be allocated based on their risk tolerance. For example, a strategic allocation for a moderate investor could be 50% stocks and 50% bonds. This “moderate” allocation could range from the relatively simple with just a few asset classes, or to a very complex allocation spanning multiple types of investments from around the globe. In any event, any deviation from that long-term allocation is a **tactical allocation**. Continuing with the 50%/50% stock-to-bond strategic allocation, if a portfolio were traded so that the new mix was 40%/60%, we would consider that a reasonable tactical move, and certainly not an attempt to “time the market.” Yet, if that portfolio were to have all of its holdings sold and placed in cash, while it would certainly qualify as a “tactical” trade, from our vantage point this would be market timing which we would strongly discourage (and against our philosophy for a long term investing strategy). The reason we would consider that “all to cash” move as market timing is the extreme degree to which the allocation was changed from its strategic allocation.

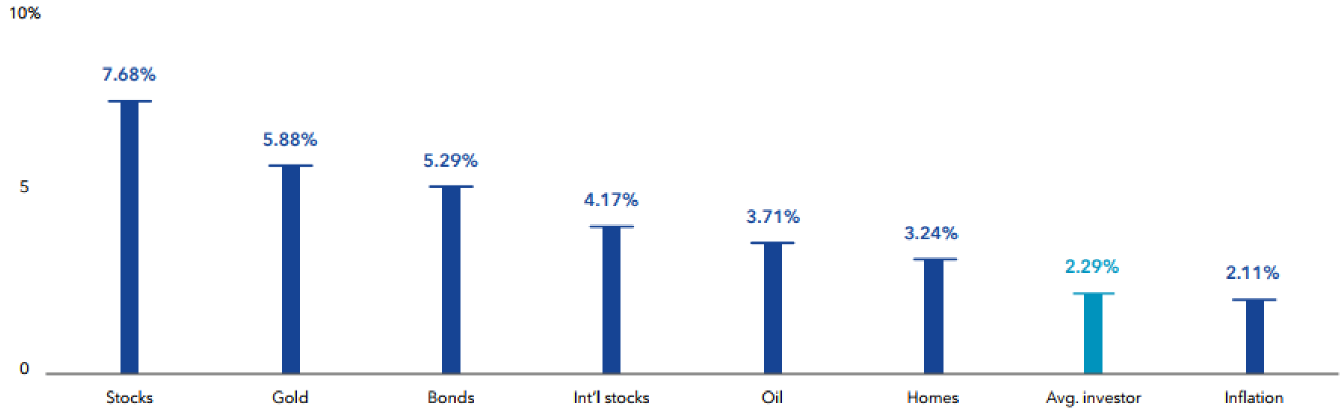
The reason for the tactical change is important as well. In our opinion, if the percentages change by a modest amount but the reasoning is based on something like an algorithm, the day of the week, a gut feeling, moving averages, oscillators, how the planets align, or even Ouija boards -- it is trying to time the market. It is true that both traders and investors tactically allocate. However, in our experience traders are attempting to time the market, whereas investors, like us, believe there is a long-term benefit to owning reasonably higher weights relative to the strategic benchmark in areas of the market that are undervalued based on fundamentals.

Why don’t we try to time the market at Baystate Wealth? The simple answer is that we don’t think it’s possible; to be sure, history has shown that predicting the future has proven to be a challenging task in any discipline, perhaps most especially markets. In addition, we think it could have a negative impact on performance over time.

In theory, selling before the market falls and buying before it rises sounds great. I certainly understand why investors would desire this type of strategy as it’s basically the holy grail of investing. In my personal experience, I’ve seen many people fail at attempts to time the market over the last 20+ years. Regardless of my anecdotal evidence, the fact is that over time, the average investor underperforms. The chart below from BlackRock, which is derived from a famous study from Dalbar, shows the returns of a variety of asset classes, including stocks, with the “average investor” over the last 20 years.

The average investor underperforms

20-Year annualized returns by asset class (1997-2016)



Sources: BlackRock; Bloomberg; Informa Investment Solutions; Dalbar. Past performance is no guarantee of future results. It is not possible to directly invest in an index. **Oil** is represented by the change in price of the NYMEX Light Sweet Crude Future contract. Contract size is 1,000 barrels with a contract price quoted in U.S. Dollars and Cents per barrel. Delivery dates take place every month of the year. **Gold** is represented by the change in the spot price of gold in USD per ounce. **Homes** are represented by the National Association of Realtors' (NAR) Existing One Family Home Sales Median Price Index. **Stocks** are represented by the S&P 500 Index, an unmanaged index that consists of the common stocks of 500 large-capitalization companies, within various industrial sectors, most of which are listed on the New York Stock Exchange. **Bonds** are represented by the BBG Barclay U.S. Aggregate Bond Index, an unmanaged market-weighted index that consists of investment-grade corporate bonds (rated BBB or better), mortgages and U.S. Treasury and government agency issues with at least 1 year to maturity. **International Stocks** are represented by the MSCI EAFE Index, a broad-based measure of international stock performance. **Inflation** is represented by the Consumer Price Index. **Average Investor** is represented by Dalbar's average asset allocation investor return, which utilizes the net of aggregate mutual fund sales, redemptions and exchanges each month as a measure of investor behavior. Returns are annualized (and total return where applicable) and represent the 20-year period ending 12/31/16 to match Dalbar's most recent analysis.

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We believe, and find it to be generally accepted, that the reason for this large disconnect is the timing of money flows. In other words, people trying to time the markets. If, on average, investors owned some allocation of mostly stocks and bonds with modest deviations away from that strategic allocation, the average return would obviously not be so low. As we have said many times at Baystate Wealth, we understand it's tempting, we get it – but don't do it.

The good news is that there are some productive things investors can do if their market-related stress levels are elevated. Our advice is twofold: first, remember the power of rebalancing; and second, re-think your risk tolerance. While headline grabbing news from around the world may cause an investor to adjust their expectations, only in extreme cases should it lead to an adjustment in their portfolio.

Although rebalancing isn't really going to help an all equity investor, most people don't pursue that concentrated of a strategy. We find that most investors hold a variety of assets including stocks, bonds, alternatives, and a variety of sub-asset classes, like large, small and mid-cap, emerging markets, etc. The benefit of this diversification is that if stock markets fall, other types of investments, like government or corporate bonds, can rise. The advantage of this dynamic is that it creates the opportunity to buy (rebalance) into equities at lower prices. If markets recover, owning more stocks at a lower price generates higher portfolio returns. It's that simple.

The bottom line is that if you find yourself concerned about markets reaching all-time highs, or the headline news reporting that the world might come to an end, remember that not everything in a truly diversified portfolio will behave the same. If you can't point to anything in your portfolio that will react differently than stocks in a broad-based market pullback, you should make sure you really have that high of a risk tolerance.

In our view, investors should be challenging their risk tolerance in the context of an annual review at a minimum. Risk tolerances often change, and it many cases, they should. We believe it's a good idea to evaluate an investor's overall risk tolerance by considering two categories of risk tolerance.

The first category is the investor's **ability to take risk.** This type of risk tolerance is mostly mathematical and ignores emotions or feelings about risk. I'll explain by way of an example with a young investor with an IRA who has 20 years until retirement. Assuming this hypothetical investor will not prematurely need money from the IRA, the ability to take risk is relatively high. On the other hand, if an investor only has a few years before retirement and will need the money within the IRA, the ability to take risk is relatively lower.

The second category, **willingness to take risk,** is a different matter. This component of risk tolerance is based on feelings and emotions. An investor may have the ability to take on risk but may have no interest in doing so. On the other side of the spectrum, which in our line of work we see a lot, are investors who have very little ability to take risk but want to take on more risk than they should in the pursuit of higher returns. Most importantly, one's willingness to take risk should be independent of recent market behavior. Stated differently, one should not adjust their risk tolerance in response to a rising or falling market.

As a word of caution: although it is perfectly normal for risk tolerances to change based on a variety of factors, frequently changing the risk profile of an investment strategy is also not a good idea. In fact, doing so is basically trying to time the market which we have already addressed is not likely to be an optimal strategy. The best solution is to discuss it with your Financial Advisor. From our vantage point, the ability to take on risk is somewhat straightforward and as mentioned earlier, is really a function of the math behind a financial plan. By contrast, to properly diagnose an investor's willingness to take risk, open and honest communication must happen.

The fact of the matter is that markets do fall and then recover and eventually move on to higher highs. Over time taking advantage of that volatility by rebalancing a truly diversified portfolio can actually enhance long-term returns. It may be concerning at the time, and it may "feel different" the next time, but history suggests it is the right thing to do. Unfortunately, as the data above shows, the average investor is clearly not doing the right thing.

The good news is that you don't have to be average. Once again, market timing is tempting – but don't do it.

If you are considering a change in risk tolerance, or even if you would just like to review your current risk tolerance, please call on us and we will be more than happy to have the discussion with you and your advisor.

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