Heritage Perspective

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The Summer Slowdown: How does it impact the markets?

Now that summer is here, your thoughts have most likely turned away from taxes and investment portfolios and towards beaches and boat drinks.

> *"There is something to that old saying, 'slow and steady wins the race.' "*

During the summer months you may be less likely to pay close attention to the capital markets and you therefore may find yourself trading less frequently in your investment accounts. Ironically, this slowdown in your trading activity is a good thing, not only for your mental health, but also for the health of your investment portfolio.

There is something to that old saying, "slow and steady wins the race." Investors often believe they need to trade frequently to take advantage of markets, when in fact the opposite is true in the context of creating sustainable long-term wealth. The summer slowdown is something you should embrace in your investments throughout the entire year, since most investors tend to trade far too often. Natural impatience and the ubiquitous financial media conspire to entice investors to respond to emotionally charged events and to chase short-term trends in the markets. Numerous academic studies have shown that this activity is counter-productive and that *lower* trading activity usually leads to higher investment returns. When you go on vacation, you are probably enhancing the performance of your investments.

The good news does not end there. Although *you* may take things a bit more slowly in the summer, the

financial markets will keep on working in your absence. As you may have heard, "money never sleeps," and it never goes on summer vacation either. The stock market does not care that you are leaving the office earlier or taking a few days off; it will continue to work for you regardless.

In fact, when it comes to investing, you should act like it's summer all year long. The angst and second-guessing that accompany many investment strategies are entirely unnecessary. Active trading is a losing proposition for most investors, and recent revelations about the

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proliferation of computerized high-frequency trading (HFT) programs have shown that the deck is more heavily stacked against the individual investor than most had previously thought.

In his latest book, *Flash Boys: A Wall Street Revolt,* celebrated author Michael Lewis shows how the microstructure of the stock market allows a small group of privileged professional traders to profit at the expense of everyone else. The advantage these traders have does not come from skill, but from their exclusive access to pricing information. Essentially, these traders and their computers are allowed to view market information a split-second sooner than you and your computer can, and this allows them to profit at the expense of other investors.

> *"One easy way to avoid being harmed by this lopsided system is to trade infrequently and patiently."*

This is bad news for traders, but it does not pose a problem for long-term investors. One easy way to avoid being harmed by this lopsided system is to trade infrequently and patiently. High-frequency traders profit by taking advantage of investors who are in a hurry to trade.

Another way to protect yourself is to own passive or indexed mutual funds. The managers of passive funds trade infrequently and the funds themselves are priced once per day, independent of the activity of high-frequency traders. Patience is most definitely a virtue, but it is particularly so when going up against high frequency traders.

Flash Boys is light, interesting summer reading, and it will keep your mind sharp as you relax on your vacation. More important, if you decide that it's better to invest wisely, trade infrequently, and allow the markets to work for you, the book will allow you to relax without worry, with the knowledge that the summer slowdown is a good thing, for both you and your portfolio.

This article was originally written by Heritage for the July 2014 edition of The Light, a local magazine serving Broward County, Florida.

The Certainty Principle

A frequent complaint from would-be investors is that "uncertainty" is what keeps them out of the financial markets. "I'll stay in cash until the direction becomes clearer," they will say. But when has there ever been total clarity? Alternatively, people who are already in the market after a strong rally, as we have seen in recent years, nervously eye media commentary about possible pullbacks and say, "Maybe now is a good time to move to the sidelines."

While these kneejerk, emotion-driven swings in asset allocation based on market and media commentary are understandable, they are also unnecessary. Strategic rebalancing provides a solution, which we will explain in a moment. But first, think back to March 2009. With equity markets deep into an 18-month bear phase, the Associated Press provided its readers with five signs the stock market had bottomed out and followed that up with five signs that it hadn't.[1]

The case for a turn was convincing. Volumes were up, the slide in the US economy appeared to be slowing, banks were returning to profitability, commodity prices had bounced, and many retail investors had capitulated and gone to cash. But there also was a case for more pain. Toxic assets still weighed on banks' balance sheets, economic signals were patchy, short-covering was driving rallies, the Madoff scandal had knocked confidence, and fear was still widespread.

> *"...rather than betting against the market, you work with the market."*

Of course, with the benefit of hindsight, that month did mark the bottom of the bear market. In the intervening period of just over five years, major equity indices have rebounded to all-time or multi-year highs. But keep in mind that these past five years of recovery in equity markets have also been marked by periods of major uncertainty. In 2011, Europe was gripped by a sovereign debt crisis. Across the Atlantic, Washington has been hit by periodic brinksmanship over the US debt ceiling. In Asia, China has grappled with the transition from export-led to domestic-driven growth.

Around any of these events, there was a broad range of views about likely outcomes and how these possible scenarios might impact financial markets. The big

question for the rest of us is what to do with all this commentary.

The fact is, even the professionals struggle to consistently add value using analysis of macroeconomic events, as we see repeatedly when comparing the investment returns of active managers against the broad market. And history suggests that those looking for "certainty" around such events before investing could be setting themselves up for a long wait.

What is the average investor supposed to make of all this conjecture? One option is to debate the market implications of news and to try to anticipate what might happen next. But whom do you believe? We've seen there are always cogent-sounding arguments from both bulls and bears.

An alternative approach is much simpler. It begins by accepting the market price as a fair reflection of the collective opinions of millions of market participants. So rather than betting against the market, you work with the market. That means building a diversified portfolio around the known dimensions of expected returns according to your own needs and risk appetite, not according to the opinions of media and market pundits about what they think will happen next month or next week.

It also means staying disciplined within that chosen asset allocation and regularly rebalancing your portfolio. Under this approach, shares are typically reduced after a solid run-up in the market. The trigger for rebalancing is not media speculation but the need to retain your desired asset allocation.

> ***"The fact is, even the professionals struggle to consistently add value using analysis of macroeconomic events..."***

Of course, this doesn't mean you can't take an interest in global events. But it does spare you from basing your long-term investment strategy on the illusion that somewhere, at some time, "certainty" will return.

[1] *"Five Signs the Stock Market Has Bottomed Out and Five Signs It Hasn't," Associated Press, March 15, 2009.*

Annuities Are Probably not the Answer for Retirees

The volatility of international financial markets since the recession of 2008 scared some investors into considering old-fashioned, lifetime income annuities for their retirement incomes. These are essentially guarantees from insurance companies: you give the insurer a lump sum of money and the insurer in turn pays you a monthly income, guaranteed to last throughout your life or your life and a beneficiary's life.

In the simplest version, a retiree gives up a fixed sum of money for a fixed benefit. For instance, a 65-year-old man would pay $1,000,000 in Florida to get a lifetime monthly principle and interest payment of $5,560, according to Immediateanuities.com. It is important to note that these payments are not comprised solely of interest earned on the annuity; a significant portion of the payments represent a return of the original principle to the annuity holder.

> *"The complexity, high cost and subtle risks of annuities make them an unattractive vehicle for most investors."*

A more complicated version has been popular among insurance agents and stockbrokers dealing with investors made uneasy by the markets: variable annuities linked to stock market investments that guarantee a minimum monthly payout, but that increase the payout if markets go up. This concept has appealed to nervous investors who want stock market performance but don't want to risk a decline in their retirement income. However, in practice, these equity-linked products tend to perform much like simple fixed annuities due to their high internal costs and limits on their ability to participate in rising equity markets. Research indicates that these products are far from being a panacea for investors.

For instance, Wade Pfau, who teaches at the National Graduate Institute for Policy Studies in Tokyo, argues that the extra internal costs of this type of annuity tend to erode the invested balance, meaning that it is less likely that the payout to a retiree will be increased during his lifetime. He notes that this would be especially true during those periods when the retiree would be most in need of increased income: periods of high inflation and low stock market performance.

Meanwhile, although the initial fixed payout may look attractive, the value of the payout will gradually decline over the years as inflation eats away at its purchasing power. "I remain concerned that prospective retirees may be overvaluing the guarantees in their minds because they are not properly considering how inflation will erode their real value over time," Pfau wrote. His research found that in some cases the guaranteed spending amounts after 30 years may decline by as much as 80% from the initial level after adjusting for inflation.

The complexity, high cost and subtle risks of annuities make them an unattractive vehicle for most investors. These are important considerations to keep in mind if you are considering exchanging a significant amount of your nest egg for what may seem like an attractive income stream.

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