

## Two Ideas Worth Thinking About When Markets are Moving

Here's a number most people would like to see on an annual statement: 21.6 percent. That was the annual return for the Standard & Poor (S&P) 500 Index during 2017. In general, U.S. stock indices did quite well last year – and the year before, too. For instance, the S&P 500 Index was up 11.8 percent in 2016.<sup>1</sup>

While no one can invest directly in an index, recent returns make it easy to understand why U.S. stock markets have been popular with investors. *Morningstar* reported record amounts of money were invested in various types of U.S. stock investments during 2017.<sup>2</sup>

Whenever large numbers of investors are doing the same thing, a prudent course of action is to step back, take a breath, and evaluate the situation. Here are two questions that deserve some thought:

### 1. Is the price or return above average or below average?

Usually, being above average is considered a positive state of affairs. That's not the case with investing. Mean Reversion Theory (MRT) suggests prices and returns eventually move back toward the average. In other words, when annual returns are above long-term averages, they're likely to move lower. The reverse is true, too. When returns are below long-term averages, they may move higher.<sup>3</sup>

Consider the S&P 500 Index. It returned 21.6 percent last year. The historic average annual total return for the Index over the last 89 years, from 1928 through 2017, was 11.7 percent. During the last 40 years, the average total return was 11.4 percent.<sup>4</sup> Therefore, 2017 returns were well above average.

That doesn't mean 2018 returns will be below average. It simply suggests investors may be buying high. In addition to prices and returns, MRT can also apply to interest rates and price-to-earnings ratios.<sup>3</sup>

MRT is the bucket of cold water that can help restore sanity when investments trade well above (or well below) historic averages.

### 2. Are animal spirits informing investors' opinions?

Animal spirits is a term economists use to describe investor behavior. The blog *Organization and Markets* explained, “The new behavioral economics literature uses the term to refer to a range of behavior which falls outside what is normally understood as rational.”<sup>5</sup>

In *Animal Spirits: How Human Psychology Drives the Economy, and Why It Matters*, co-authors George Akerlof and Robert Shiller said animal spirits are often inspired by ‘new era’ stories that “purport to describe historic changes that will propel the economy into a brand new era.”<sup>6</sup>

You don’t have to think very hard to remember one of the greatest new era stories ever. The story was about the future of the Internet, and it led to the dot.com bubble. The storytellers weren’t wrong. The Internet *was* important new technology that ushered in a new era. However, investors were so inspired they got carried away and the world experienced one of the biggest stock market bubbles of all time.<sup>6,7</sup>

### **Back to Basics**

It’s not difficult to identify today’s new era stories, either. Peruse the research of any bank or investment house and you’ll find captivating tales about the potential of self-driving cars, facial recognition software, space exploration, and life-extending medical innovations.<sup>8</sup>

There is no shortage of investment opportunities with the potential to deliver attractive returns. In fact, there are so many it can be easy lose sight of basic investment principles.

When you find yourself inspired by the potential of new era stories, and you consider moving more of your savings (perhaps, all of it) out of investments that have been chosen specifically to help meet your financial goals, it’s time to remember the foundational principles of investing. These include:

- 1. Defining measurable and attainable financial goals.**<sup>9</sup> Typically, your goals should describe what your money should do for you. Every goal should be measurable so you know if you are saving enough. Additionally, every goal should have a time frame attached. For example, a goal might be:
  - A retirement income of \$5,000 each month for the rest of your life
  - \$100,000 in savings to put toward your child’s college tuition in 14 years
  - Leaving a million dollars to each of your children or grandchildren
  - Providing lifetime income for a child with special needs
  - Being able to afford healthcare in retirement
- 2. Developing allocation strategies to reach your goals.**<sup>10</sup> Choosing an asset allocation strategy and diversifying investment holdings may help manage risk effectively. Typically, asset allocation strategies blend stocks, bonds, cash, and other investments to balance risk and potential reward.

- 3. Maintaining a long-term perspective.**<sup>11</sup> Animal spirits often inspire impulsive investment decisions – the kind that can undermine the success of any financial plan. When market gyrations tempt you to make significant changes to your portfolio, even though your financial goals remain the same, contact your financial advisor. He or she may need to talk you down.

The basic principles of investing remain fairly constant. Human emotion, however, is quite variable. When emotion tries to jump into the front seat and drive your investment choices, apply the brakes by evaluating MRT and animal spirits.

If you would like to talk about markets or review your financial plan, give us a call.

Sources:

<sup>1</sup> [http://pages.stern.nyu.edu/~adamodar/New\\_Home\\_Page/datafile/histretSP.html](http://pages.stern.nyu.edu/~adamodar/New_Home_Page/datafile/histretSP.html)

<sup>2</sup> <http://www.thinkadvisor.com/2018/01/29/passive-investments-drive-record-fund-flows-in-201>

<sup>3</sup> <https://www.investopedia.com/terms/m/meanreversion.asp>

<sup>4</sup> <https://www.bloomberg.com/view/articles/2018-01-29/low-volatility-stock-returns-aren-t-the-long-term-norm>

<sup>5</sup> <https://organizationsandmarkets.com/about/>

<sup>6</sup>

[https://books.google.com/books?id=2Rz\\_cuu88DwC&printsec=frontcover&dq=Keynes+animal+spirits&hl=en&sa=X&ved=0ahUKEwidx5ahIYDZAhVEwYMKHWxlCnYQ6AEIjzAA#v=onepage&q=Keynes%20animal%20spirits&f=false](https://books.google.com/books?id=2Rz_cuu88DwC&printsec=frontcover&dq=Keynes+animal+spirits&hl=en&sa=X&ved=0ahUKEwidx5ahIYDZAhVEwYMKHWxlCnYQ6AEIjzAA#v=onepage&q=Keynes%20animal%20spirits&f=false)  
(or go to [https://s3-us-west-2.amazonaws.com/peakcontent/Peak+Documents/Mar\\_2018\\_Animal\\_Spirits-Book\\_Excerpt.pdf](https://s3-us-west-2.amazonaws.com/peakcontent/Peak+Documents/Mar_2018_Animal_Spirits-Book_Excerpt.pdf))

<sup>7</sup> <http://money.cnn.com/2017/12/08/investing/bitcoin-tulip-mania-bubbles-burst/index.html>

<sup>8</sup> <http://www.goldmansachs.com/our-thinking/pages/what-if-i-told-you-full/index.html>

<sup>9</sup> <https://www.saveandinvest.org/military-everyday-finances/set-smart-goals>

<sup>10</sup> <https://www.forbes.com/sites/rickferri/2012/12/03/asset-allocation-basics-for-investors-part-1-of-2/#4080e75612c4>

<sup>11</sup> <http://news.morningstar.com/classroom2/course.asp?docId=145666&page=2&CN=sample>

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