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“Recency bias is the tendency to think that trends and patterns we observe in the recent past will continue in the future... Predicting the future in the long term according to what has recently occurred has been shown to be no more accurate than flipping a coin in many fields, including meteorology, economics, investments, technology assessment, demography, futurology, and organizational planning.” -- William Sheridan -- “The Future Sellers.”

We see evidence of recency bias nearly every day as we monitor the dynamics of the capital markets and investor behavior. Last year, we saw the S&P 500 outperform most other major indices. The U.S. markets did better than most others in the world. As 2015 began, many people were recommending an overweight in U.S. stocks (expecting the recent trend to continue). As the New Year began, many individual investors were adjusting their portfolios to have more large-cap stock exposure (to be more like the S&P 500). In the business, we call this “chasing performance.” Many investors (overcome with recency bias, no doubt) identify the best performing investments and want to buy more of them. Or they will sell underperforming ones. We have decades of data indicating that individual investors generally underperform not only the market, but will achieve returns worse than the long-term returns of the assets they actually own. Why does this happen? They panic in bad times (bear markets) and often become overwhelmed with enthusiasm at market peaks. Selling in a bear market may feel right, but it is usually the worst thing to do. More on bear markets after the review...

First Quarter Review

For the quarter, nearly every major index showed positive returns. Commodity prices, especially oil, continued the decline started last summer. European markets, emerging markets and small caps all did better than the S&P 500, a reversal from last year. In fact, the U.S. market has lagged most others this year so far. Japan’s stock market recently hit a 15-year high. Europe seems to be turning around, thanks to accommodative monetary policies nearly everywhere, and even many emerging markets seem to be close to a positive inflection point. Talk about when the Federal Reserve will “lift off” (begin raising rates) has become a major point of discussion in recent months. The U.S. 10-year bond continues to offer yields below 2% - something one would expect in a recession and not an economic recovery.

Here is what the first quarter looked like by the numbers:

Index	1 st Qtr 2015	Year to Date	Trailing 12 Months
Dow Jones Industrial Average	0.3%	0.3%	10.6%
S&P 500	1.0%	1.0%	12.7%
NASDAQ	3.5%	3.5%	16.7%
Russell 2000	4.3%	4.3%	8.2%
MSCI EAFE	4.9%	4.9%	-0.9%
MSCI EAFE Small Cap	5.6%	5.6%	-2.6%
MSCI Emerging Markets	1.9%	1.9%	-2.0%
Barclays Aggregate Bond	1.6%	1.6%	5.7%
Barclays Municipal Bond	1.0%	1.0%	6.6%
Dow Jones Commodities	-6.0%	-6.0%	-27.0%

Bear Markets

One of the most distinctive of the many color elements of Wall Street nomenclature is the image of the bull and the bear. We define bull markets as those periods of time when stock prices are rising, regardless of how high or for how long. To qualify as a bear market, on the other hand, the broad indices need to fall at least 20%. Market declines less than 20% we call "corrections."

We find the animal symbols used to describe these different types of market conditions somewhat curious. Granted, the image of the bull is strong, powerful, and macho. Yet, if one considers what a bull does for a living (mostly grazing in a protected environment and breeding), it doesn't really seem that impressive. In a bull market, everyone makes money and everyone looks like a genius. Much like the bull, investors in a bull market need not work very hard to achieve acceptable results. Buy and hold will often be a winning strategy in a bull market.

The bear seems to be a more ominous character (42 people in North America have been killed by bears since 2000). Yet, the lifestyle of the bear represents a reasonable template of how investors should act in a bear market. The bear has to work hard for every morsel of food. Being omnivorous, the bear will seek out food in trees, bushes, grasses, rivers and just about anywhere it can find it. Bear market investors also need to work harder to find those stocks that can actually rise within the context of a bear market. Bear market investors may also need to trade more actively to achieve better returns when the markets are moving down. Bears are also good at preparing for hard times. When food is plentiful, they are able to store some of what they eat as fat that will sustain them during the winter. They also tend to hibernate for as long as 7 months in lean times. The bear market investor too may need to simply hunker down and wait out the volatility storms that often accompany bear markets.

Bear markets are no fun, but they are not the end of the world either, although

sometimes they might make one feel that way.

Black, Brown or Grizzled

With apologies to Tolstoy, we would offer that bull markets are all alike; every bear market is unhappy in its own way. There is a tendency during a bear market for investors to quickly conclude that: 1) this time around it's like nothing before, 2) it's clearly worse than the last time and 3) things may never get better. This mentality abounded in the global financial crisis of 2008-2009.

The causes of bear markets can be broadly grouped into just a few categories. First is what we call "excesses." The nature of the excess can be different each time, but most market tops exhibit some kind of "irrational exuberance." Excesses in investor sentiment, consumer or corporate borrowing, economic growth, valuation and so on are often coincident with market peaks. The second cause is tight monetary policy. Often the Federal Reserve will raise rates (or "take away the punch bowl") in response to some of these excesses. Regardless of the intention, Fed tightening often leads to recessions and bear markets. The third cause is exogenous shocks – unexpected bad stuff happens. Sometimes they represent the "pin prick" to deflate an asset bubble. Sometimes they just come out of nowhere to scare the market into bear territory.

This clear-headed categorization and analysis of bear markets happens only after the fact. During a bear market, we only hear the hopeful pronouncement of strategists telling us that the current correction will not lead to a full bear market, or the less hopeful ones stating that because the market has already gone down 20%, it's likely not to get worse. Panic sets in when it actually gets worse. Investor sentiment clearly suffers in a bear market, and the emotional part of the brain takes over. This is why most individual investors want to do something (the "fight or flight" instinct) when they start losing money. Although it is perfectly human to feel this way, it is also a perfectly bad way to invest. The research by Boston-based Dalbar, Inc. indicates that the returns of most do-it-yourself investors significantly lag not only broad indices, but also the mutual funds they actually own. They do this by selling low and buying high. Bear markets are the key reason that some investors feel the need to sell low.

Bear Markets of the Past

To show that they are not that common and ultimately not that scary, let us take a quick look at the bear markets of the last seven decades. Remember that the market recovered from each of these bear markets to reach new highs in the next bull market.

Post WWII Bear – 5/29/46 to 6/13/49 – duration 3 years – decline 24%. The euphoria that came with the ending of hostilities soon turned into an investor recession (November 1948 to October 1949) as Americans plowed more money into savings than consumption.

Cold War Jitters Bear – 12/31/61 to 6/26/62 – duration 6 months – decline 27%. Tensions

between the U.S. and the USSR peaked following the Bay of Pigs invasion and the threat of Russian nuclear missiles in Cuba.

Tight Money Bear – 2/9/66 to 10/7/66 – duration 8 months – decline 25%. In response to a booming U.S. economy, the Federal Reserve aggressively tightened monetary policy so much that it threatened the profitability of the banking sector. A muni bond market credit crunch also helped to drive down stock prices.

Inflation Shock Bear – 12/3/68 to 5/26/70 – duration 1.5 years – decline 36%. As the summer of love melted into the horrors of riots, assassinations, anti-war-sentiment, rising inflation and another round of tight money, stock prices fell as the economy fell into recession (December 1969 to November 1970).

Oil Shock Bear – 1/11/73 to 12/6/74 – duration 2 years – decline 45%. The Yom Kippur War and the subsequent Arab oil embargo sent inflation sailing (it peaked at 10%) and the economy into a long, hard recession (November 1973 to March 1975).

Inflation Fears Bear – 9/21/76 to 2/28/78 – duration 1.5 years – decline 27%. Although the U.S. economy performed well during this period (no recession), investor fears about the persistent damage inflation might have on the country drove share prices lower.

Stagflation Bear – 4/27/81 to 8/12/82 – duration 1.5 years – decline 24%. After nearly a decade of rising inflation, the Federal Reserve put the hammer down and raised Fed Funds to nearly 20%. This caused a recession (January 1980 to July 1980), but set the stage for a secular bull market in bonds that continues today.

The “Crash” of ‘87 Bear – 8/25/87 to 10/19/87 – duration 47 days – decline 36%. The Federal Reserve had begun to tighten in 1986, but the use of “portfolio insurance” where professional investors could (supposedly) protect their downside risk by simply pushing a button led to everyone pushing the button at the same time leading to the biggest single-day decline (22.6%) since 1914. Ironically, today we refer to this “crash” as a market “break” or “pause.”

Gulf War Bear – 7/16/90 to 10/11/90 – duration 3 months – decline 21%. Rising oil prices combined with a lingering savings and loan crisis to dampen investor spirits for a brief period.

Tech Bubble Bear – 1/14/00 to 9/21/01 – duration 18 months – decline 30%. The widely expected technology “paradigm shift” turned out to be just another case of “irrational exuberance.” Technology stocks performed much worse than the market in this period.

9-11 Bear – 3/19/02 to 10/9/02 – duration 7 months – decline 31%. The terrorist attacks surprised the nation and dampened investor sentiment for a short time.

Great Recession Bear – 10/9/07 to 3/9/09 – duration 17 months – decline 53%. The popular press tried to blame Wall Street and bankers for this bear market, but the actual causes were more complicated. The fear created by this one still lingers in the minds of

investors today.

Current Bull Market

We all know that stock prices bottomed in the first quarter of 2009. This was not a time when most investors were confident about the future. We recall serious commentary suggesting that the stock market would never recover from this. Such is the nature of sentiment at stock market troughs. Although fundamentals ultimately matter, in the short run, investor emotions can be the key driver of stock prices. The oft-cited chart below illustrates investor sentiment at the various stages of the market cycle.



Market commentators will tell us that the average bull market lasts about 4 years. The current bull market is much older than that, having just passed the 6-year mark. However, bull markets don't die of old age. They usually end because of systemic excesses and ebullient investment sentiment. Typical bull market excesses include things such as excessive borrowing, stretched valuations, the perception of "no risk" investments, high and rising interest rates, unsustainably high economic growth and so on. We see none of the traditional excesses right now in the market. The market's valuation has risen mostly in line with profit growth. Low interest rates have been a help to share price appreciation, but they have clearly not been the only factor pushing the market higher. Investor sentiment is impossible to measure with complete accuracy, but a general feeling of euphoria among investors seems absent. This can be measured by the great concern expressed by the market experts and the anecdotal evidence speaking with individual investors whenever the market corrects a few percentage points. In a euphoric market, investors would view any weakness as a buying opportunity and pour more money into the market. We have not seen this behavior yet in this cycle. This gives us some degree of confidence that the current bull market is likely to persist for a while longer.

The Next Bear Market

The current bull market will eventually end. At some point, the major stock market indices will decline 20% or more and investors will be as afraid as ever. The next bear market will likely have some new angle that will make it appear quite different from those of the past. Market gurus will tell us why "this time is different," and may recommend selling stocks as we approach the market's nadir. The cause of the next bear market could be tight monetary policy, a recession or some external shock. Massive overvaluation of stocks (or other assets) may precede it. Whatever the cause, the next bear market will be unpleasant for most of us.

So what can we do about this eventuality? Selling stocks before the bear market occurs requires timing skills that no one really has. Selling stocks also creates another timing problem – when does one get back in? The market peaked in 2007 at a time when things looked rosy for the U.S. economy and the stock market. We do not know anyone who sold a sizable chunk of their equity holdings at this time, unless they sold them to buy some more inflated real estate just before those prices fell! Even if one had sold in late 2007, how likely was that person to buy stocks in late 2008 or early 2009? Clearly, trying to time the market does not work.

The right thing to do in front of a bear market, which like so many things in investing, is highly contrary – expect it, do not over-react and embrace it.

One can begin to expect a bear market amid signs of euphoria. Nothing is a sure indication, but when you hear non-professionals taking about all the money they are making in stocks or how this or that is a "no-brainer" investment, a bear market may be just around the corner.

We know from recent studies that our brains respond in a very primitive way when we lose money. Our natural reaction is to sell, sell, sell! This is what we mean by over-reacting. Making emotional decisions regarding one's portfolio is a sure-fire recipe for underperformance. As the bear market begins, we will experience anxiety, denial, fear and desperation. This is normal. Selling stocks when we feel panic, capitulation or despondency is the worst thing we can do. Doing nothing may be more promising than reacting to price declines.

So how can we embrace a bear market? The secret to enduring a bear market is the understanding that prices cannot go down forever and that the bear market will end eventually. The average duration is one year, and the average decline is about 27%. The market has recovered from every single bear market. The long-term trend for stock prices is upward. Investing is not a zero-sum game. Those who feel the need to do something in a bear market should consider buying more stocks as pricing decline. It will likely feel weird to do this, but it will likely increase one's long-term wealth.

The Outlook

In the near term, expectations for growth in the U.S. economy and corporate earnings are muted. Reasons for this include the strong U.S. dollar, bad weather in February, a West Coast dock strike, etc. Most experts think this weakness will be temporary, and that

the GDP for the year will come in around 2.5%. Consensus expectations call for the Federal Reserve to begin raising interest rates as soon as June. We think that the Fed's decision will be driven by the data and not the calendar. Moving to a less accommodative (but still "easy" by any measure) policy should signal that the U.S. economy has strengthened – a good thing for stock prices. In theory, higher short-term rates do not necessarily translate into higher rates all along the yield curve. Investors have been expecting higher interest rates for many years now, but the bond market continues to be uncooperative. We think that bond investors should begin to expect returns to be no higher than the current yield-to-maturity going forward. This remains an attractive return relative to expected rates of inflation, and holding bonds in one's portfolio still lowers overall volatility. We continue to think that cash (beyond some reasonable "rainy day" reserve) is the worst asset for investors to hold.

We would remind our clients that bull markets do not die of old age, but they usually end just before a recession begins or when investor sentiment reaches euphoric levels. We sense we are still far away from either of these situations.

Whenever we feel overly concerned about "the market" (instead of focusing on managing the assets our clients actually own), we remember the words of the legendary investor, Sir John Templeton, "I never ask if the market is going to go up or down, because I don't know, and besides it doesn't matter. I search nation after nation for stocks, asking: 'Where is the one that is lowest priced in relation to what I believe it's worth.'"

Sincerely,

Wolf Group Capital Advisors

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