Adam Smith Advisors

A Cherry Tree Affiliate

October 2017

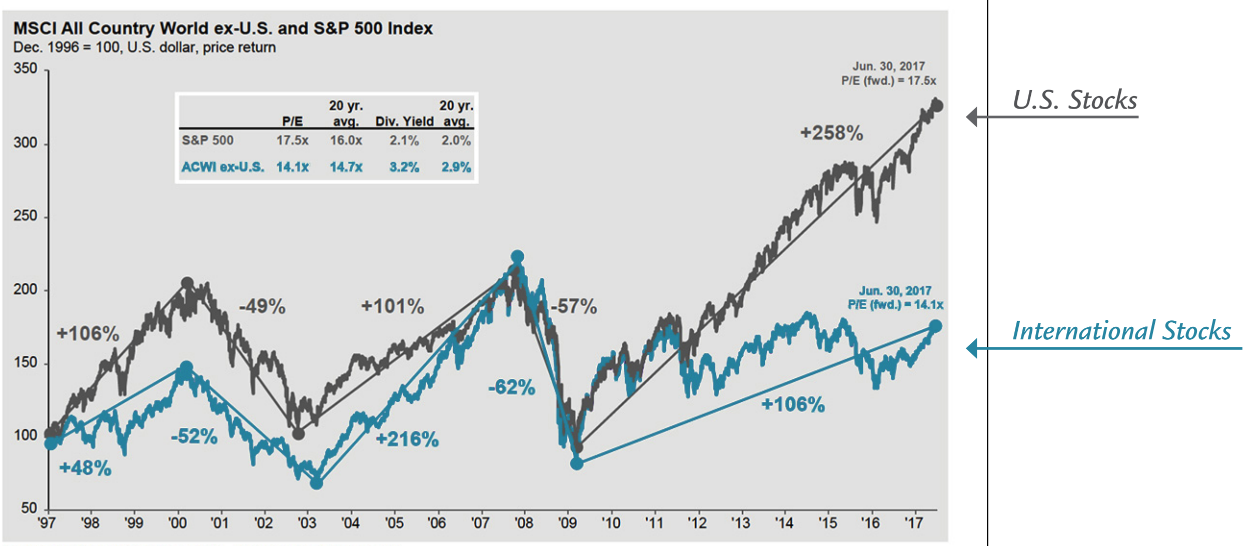
ADAM SMITH INSIGHTS: *Published by Keith Tufte, President of Adam Smith Advisors, LLC, with insights on investing and wealth management.*

INVESTING QUOTE OF THE MONTH:

"How well you adhere to your investment allocation is more important than what the exact investment allocation is." – William Bernstein (famous investor and author)

STOCKS ARE HIGH, WHAT SHOULD I DO?

U.S. stocks are currently at or near all-time highs, and are up over 250% over the past eight years. See the grey line (for the U.S. S&P 500 stock market index) on the graph below. Is this the top?



Source: MSCI, Standard & Poor's, FactSet, J.P. Morgan Asset Management.
Forward price to earnings ratio is a bottom-up calculation based on the most recent index price, divided by consensus estimates for earnings in the next twelve months (NTM), and is provided by FactSet Market Aggregates. Returns are cumulative and based on price movement only, and do not include the reinvestment of dividends. Past performance is not indicative of future returns. Dividend yield is calculated as consensus estimates of dividends for the next twelve months, divided by most recent price, as provided by FactSet Market Aggregates.
Guide to the Markets – U.S. Data are as of June 30, 2017.

J.P.Morgan Asset Management

RISKS OF A CRASH?

After many years of excellent gains, U.S. stocks are definitely not cheap. This does not necessarily mean that stocks are likely to crash anytime soon. Stock price levels could also just stay about where they are for the next five years to correct for the current high valuations. Unfortunately, no one (including us) can predict the near-term direction of the stock market with any consistency. Bear markets are often associated with rising interest rates and/or economic recessions. We currently have increasing short-term interest rates thanks to the Fed, but there are few signs of an imminent economic recession. Since 1928 the U.S. stock market has dropped at least 20% twenty one different times, or an average of once every four years. It has corrected over 30% on average every ten years. We have experienced two stock market drops of 50% in the last twenty years (see the graph above). There has not been a U.S. economic recession or large stock market correction in eight years, so some think we are now overdue.

WHAT SHOULD INVESTORS DO?

Investors should expect, and be mentally prepared for, another significant stock market correction in the next few years, simply because they are normal. That does not mean that investors should sell most of their stocks now and wait for the markets

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to drop. Many investors have become complacent over the past eight years, and their appetite for risk and confidence has gone up right along with the markets. That happens every cycle. Once the market starts to drop significantly, people find out their tolerance for losses is actually smaller than they thought. Can you really handle a 20%-30% drop in the stock market without losing sleep and wanting to sell stocks low to stop the pain? If your equity portfolio is $2 million in size, a 25% drop in stocks would result in a loss in value of $500,000, and an equity portfolio that is now only worth $1.5 million. Sometimes putting the potential losses in dollar terms causes people to realize they really don't want to risk losing that much money.

At stock market highs (like today), it is a good time to reflect on your risk tolerance, portfolio allocations, investment goals, and cash needs over the next five years. It is probably a good time to rebalance your portfolio back to your targets if you have not already done so. That would likely involve trimming back on U.S. stocks (which have performed the best), and adding to bonds and possibly international stocks. As you can see from the graph on the previous page, international stocks (the blue line) are up less than half as much as U.S. stocks over the past eight years. We rebalance our client portfolios on a regular basis.

If you will have significant cash needs in the next five years to buy a house, a new car, a business, pay for your children's college costs, etc. you may want to set aside the money for these by investing in bonds (and not in stocks) to preserve their value.

After several years of great stock markets you may realize that you have achieved (or nearly achieved) your financial goals faster than expected, and now don't need to take as much risk to reach them. In this case, you can afford to reduce your portfolio risk and stock/bond target allocations now and take some profits in equities. Now is also a good time to gift appreciated stock to charities which results in doing a good deed, getting a tax deduction, reducing your equity exposure, and avoiding the tax on the capital gain.

It is important to have a plan now for a stock market crash. Can you (and your portfolio) handle a 25%+ decline in stocks? What will you do if the markets crash? If you are like most people, your emotions (fear) and the media (scary news) will make you desperately want to sell stocks during a big market drop. It is very important to ride out any downturns and not sell near the bottom. If you chicken out and sell near the bottom, you will likely experience a permanent loss of capital. This is one of the biggest investor mistakes you can make, and we want to be sure none of our clients make it. It is easier psychologically for younger people who are still working and saving money to ride out bear markets than it is for retirees.

> **"If you chicken out and sell near the bottom, you will likely experience a permanent loss of capital."**

We do not recommend that you make significant changes in your stock/bond portfolio targets based on anyone's near-term market forecast (which are likely useless), but only if there are changes in your personal financial situation. If you want to make your portfolio a little bit more conservative, now is the time to do so, not after it has already fallen by 15%. Keep in mind that if your portfolio is invested 50% in stocks and 50% in bonds, your portfolio will likely only drop by about half the amount of the stock market drop. The long-term direction of the stock market is up, and historically it has typically only taken a couple of years to earn back stock market drops. Now is the time to make sure your portfolio is conservative enough for you to ride out the next stock market drop, and then mentally commit to riding it out no matter what.

Adam Smith Advisors, LLC (ASA) provides unique wealth management services for a select group of client families to help give them peace of mind. Author Keith Tufte, (CIO of ASA) has over 25 years of successful investment management experience as a Wall Street Analyst, Mutual Fund Portfolio Manager, Director of Equity Research for a major mutual fund firm, Hedge Fund Portfolio Manager, and Wealth Management Advisor. Please FORWARD this e-mail to friends/relatives/business associates that you think may have an interest. Please see our website at http://www.cherrytree.com.

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