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EYE ON THE MARKET

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COMMENTARY ON SPECIFIC MARKET ISSUES AND ACTIONABLE IDEAS TO CONSIDER

BIG AND SMALL RISKS:

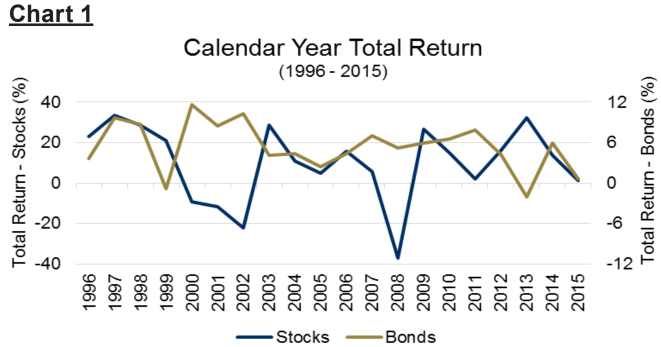
Protecting against the unknowable. Maybe?

In response to the UK referendum vote ("BREXIT") on June 23, global equity markets sold off significantly in the early hours of the trading day as the decision to leave the European Union was an unanticipated outcome for most market participants. Whether this outcome could have been predicted is beyond Eye on the Market ("EOTM"), as we leave predictions to pollsters. A common theme that I have touched on time and time again is downside-risk mitigation. One way an investor can improve the odds of meeting his financial objectives is to lose less.

PROTECT YOUR NECK

One of the ways for an investor to minimize the risk of loss is to avoid putting all of his eggs in one basket. By diversifying across multiple asset classes, including stocks, bonds, and cash, he will likely have assets that move in different directions and to differing degrees. This is ultimately what a diversified portfolio is supposed to accomplish. As Chart 1 displays, over the last twenty years stocks and bonds, as represented by the S&P 500 and the Barclays U.S. Aggregate Bond Index, have not moved in tandem. In fact, the two have tended to move in opposite directions, making them "negatively correlated assets." Given the difficulty in predicting which asset classes will outperform and when, a diversified approach can help an investor participate in both gains and losses throughout changing market cycles.

Chart 1



Source: Morningstar Direct and Raymond James. Stocks in the graph represent the S&P 500, an unmanaged index of 500 widely held stocks that is generally considered representative of the U.S. stock market. Bonds in the graph represent the Barclays U.S. Aggregate Bond Index, which is composed of investment grade U.S. Treasury bonds, government-related bonds, corporate bonds, mortgage pass-through securities, commercial mortgage-backed securities and asset-backed securities that are publicly offered for sale in the United States., and is generally considered to be representative of the U.S. bond market.

"Investing is an exercise in patience, as success is not measured at the end of day or even a single year, but over longer periods of time."

BRING THE PAIN – NO THANKS!

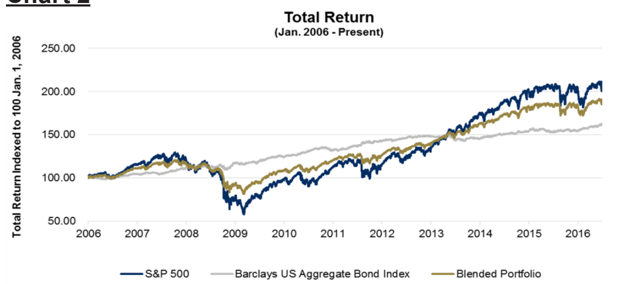
While the immediate effects of the BREXIT vote were negative for most equities, most markets recovered those losses in short order, serving as a reminder to investors that not all risks are predictable. Known risks at a portfolio level, including elevated valuations, the default risk of creditors, or rising interest rates, can be mitigated using various strategies that, in essence, can serve as a form of insurance. It is no different than a homeowner purchasing insurance in case a pipe bursts or a tree falls on the roof. While these are unlikely events, they are risks that a homeowner faces. Unknown risks, on the other hand, are difficult if not impossible to anticipate. In many cases, the only way to avoid these risks is to bury your nest egg in the back yard.

A more prudent way to limit his exposure to risk is to maintain a properly diversified portfolio that is in line with his long-term objectives and goals. As he considers what assets to include in his portfolio, identifying strategies that have demonstrated a history of limiting downside risk will further assist in meeting those goals. Ultimately, most investors are not looking to lose money, or at least lose less than the overall market.

PATIENCE OF A MONK

Investing is an exercise in patience, as success is not measured at the end of day or even a single year, but over long run. Chart 2 plots a two-asset 60/40 portfolio, consisting of the S&P 500 and the Barclays U.S. Aggregate Bond Index, compared to both of their respective indices since the beginning of 2006. As the chart shows, the blended portfolio declined less during the economic crisis, and has benefitted from the growth in equity markets afterwards. In this hypothetical example, it is worth noting that the blended portfolio captured nearly 85% of the S&P 500's return, while only taking on 75% of the risk.

Chart 2



Source: Morningstar Direct. An Index cannot be directly invested in. Past performance is no guarantee of future results. The Blended Portfolio represents 60% allocated to the S&P 500 and 40% allocated to the Barclays U.S. Aggregate Bond Index.

While there will always be the temptation to invest in the latest idea with "endless upside potential," often it is those investors who are disciplined and patient that have the most success. An investor who doesn't react during market events such as BREXIT would not only remain calm, but would also see an opportunity to buy when the markets sold off. To that end, Mutual Fund Research & Marketing ("MFRM") seeks to identify managers that have demonstrated, over time, the ability to manage known risks and avoid unknown ones.

SIDE NOTE

Many of us enjoy time with family, barbeques, and fireworks on July 4th. As we all collectively enjoy the day it should be noted that our founding fathers were willing to step into the great unknown when – in 1776 – they declared independence. As we can all attest, the risk they took has paid off rather nicely some 240 years later.