LEWIS
WEALTH MANAGEMENT

Newsletter

July 17, 2024

Executive Summary

We face a very stressful presidential election cycle. Political violence has already reared its ugly head.

At times like these, fear can take over our investment decisions.

It is wise to re-commit to the fundamentals of evidence-based investing, which is the process of making decisions based on decades of research and historical data.

Those fundamentals are: 1) risk and return are always related; 2) unsystematic risk should be eliminated through diversification; and 3) markets are very efficient and cannot be beat in the long run.

Historical returns show that staying invested at all times beats trying to invest based on which party is in the White House – by a lot.

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Market Data as of June 30, 2024

		YTD 2024
US Equities	S&P 500 ETF	15.21%
International Equities	MSCI EAFE ETF	5.38%
Emerging Markets Equities	MSCI Emerging Mkts ETF	6.84%
US Bond Market	iShares US Core Bond ETF	-0.62%
Commodities	S&P GSCI Comm ETF	10.50%
Real Estate	iShares US Real Estate ETF	-2.95%

A Stressful Election Cycle

We face a very stressful presidential election cycle. Making matters worse was the attempted assassination of former President Trump last Saturday. Fortunately, it looks like he will be okay. It was very, very close. There is a lot going on, and political rhetoric has been overheated for quite some time. What does this mean, if anything, for our investment portfolios?

At times like these, fear can take over our investment brains. We react, we search, we worry, we stress, and we panic. Poor decisions may follow, and those decisions often compromise our long-term goals.

It is a good time to go back and revisit the fundamentals of evidence-based investing, which is the process of making decisions based on decades of research and historical data. The following principles have been fully tested by academic research over decades. Three Nobel Prizes have been awarded to the economists who proved them.

Fundamental One - Risk and Return Are Always Related

Risk and return are always related.[1] ***If you want to increase your return, you must take more risk. If you want to reduce your risk, you must accept lower expected returns.***

This relationship has been proven again and again, but many investors refuse to believe it. In my experience, there is no more dangerous investor than the fearful one who wants to take less risk but will

[1] Harry Markowitz, Diversification and Portfolio Risk, University of Chicago (1952), Nobel Prize in Economics, 1990. William Sharpe, Stanford University, Single-Factor Asset Pricing Risk/Return Model (1964), Nobel Prize in Economics, 1990.

not accept lower returns. At times, they can make disastrous decisions. Ask Bernie Madoff's former clients about that. Or the yield-focused bond investor who proudly announces they have locked in a guaranteed 8% return on an emerging market bond only to have the issuer default and lose everything.

Investors should design their portfolios to take on an appropriate amount of risk given their tolerance. This level of risk should provide a long-term return that meets their financial goals. ***If there is a disconnect between the risk you can take and the returns you need, it is time to go back to the drawing board.***

Fundamental Two - Diversification Can Eliminate Unsystematic Risk

Diversification can eliminate unsystematic risk in a portfolio.[2] Research shows that there are two types of risk: systematic and unsystematic. Systematic risk is a vulnerability to events that affect all market outcomes. The pandemic is a good example of a systematic risk. All stocks were affected. Unsystematic risk is a vulnerability to events that affect a single company or sector. The collapse of Enron would be an example of unsystematic risk. Research shows that unsystematic risk can be eliminated through diversification. Smart investors avoid unsystematic risk.

Even though investors know that diversification is important, they continue to be devastated by unsystematic risk. Many Enron employees invested their entire 401(k)s in Enron stock. When the company suddenly collapsed, they lost everything. Many investors in private hedge funds sink all their money into a single strategy and lose everything when it fails – even though the manager said the fund was "fully diversified." Or an investor inherits a large stock position when a parent passes away and does not want to diversify this position because "Dad told me never to sell this stock." The list goes on.

During stressful periods, some investors will gravitate toward the apparent safety and security of a single investment. It may be a stock, a whole life insurance policy, an annuity, a private hedge fund, or a real estate investment. Simplicity can give comfort. But make no mistake, a lack of diversification can be deadly.

Investors should design their portfolios to be fully diversified, which is not difficult to do with the wide variety of mutual funds and ETFs that are available. ***Never invest more than 5%-7% of your portfolio in one single investment or strategy.***

Fundamental Three - Markets Are Efficient and Cannot Be Beat Over the Long Run

Markets are very efficient.[3] ***Asset prices reflect all available information.*** Therefore, it is futile to try to beat the market over the long run since market prices only react to new information that cannot be forecasted accurately. And with today's technology, new information is absorbed by the market in a matter of seconds.

The best strategy is to buy and hold a well-diversified portfolio over a long period of time – even during stressful times.

Many investors refuse to accept this well-known research. Somehow, they are smarter. They are better informed than the "average investor." They can accurately forecast the market. They can win at the investment "game." And if you are not overconfident about your own abilities, Wall Street is ready to introduce you to a bunch of people who will tell you they can beat the market for you. After all, they have

[2] Id.
[3] Eugene Fama, Efficient Markets Hypothesis, University of Chicago (1966), Nobel Prize in Economics, 2013.

"superior proprietary research." In stressful times, investors are very vulnerable to the next Wall Street pitch. Buyer beware.

Investors should design their portfolios to efficiently capture the market return of different asset classes. Those returns have historically provided investors with the returns they need to meet their long-term goals. ***Patience and discipline are key.***

<u>Focus on Long-Term Investing, Not Short-Term Speculation</u>

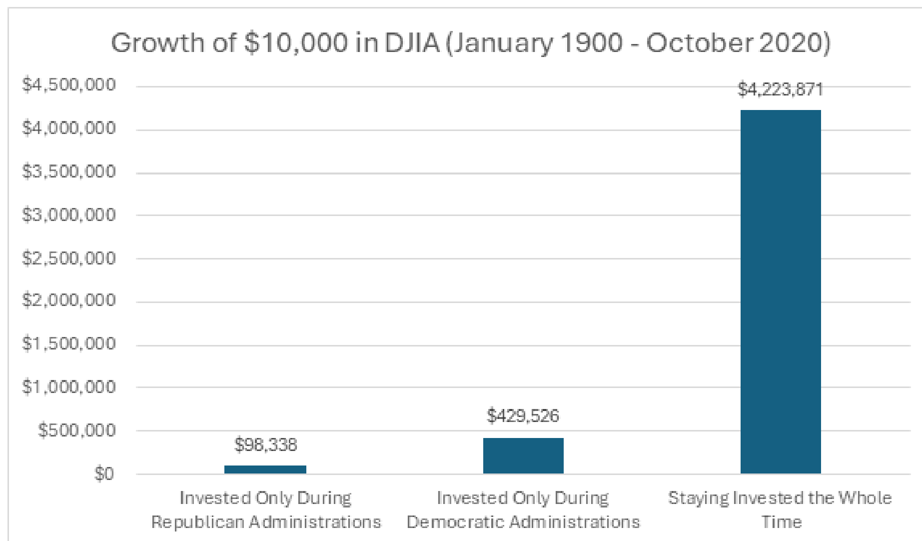
All this research leads to the following: Focus on long-term investing and avoid short-term speculation. Long-term investing creates real wealth over time. As the investor, you are providing capital to companies so they can grow and run their businesses for profit. Real investing takes years of patience and discipline.

On the other hand, speculation involves making a bet against someone else that the value of something is going up or down, usually on a short-term basis. Because there are two sides to every bet, there is a winner and a loser. It's a zero-sum game. At the end of the day, no real net wealth is created other than by those who receive a fee for making the market where you place your bets. To win as a speculator, you must be right many more times than you are wrong over a long period of time. This can be a very daunting and expensive task.

Investors should hold a diversified portfolio of stocks and bonds for the long term. It is difficult to come out ahead as a speculator. Speculation includes jumping in and out of the market, playing hunches, or trying to forecast what might happen in the short term. ***When people complain that the stock market is a "casino," I think of investors obsessed with short-term speculation.***

<u>Investing Around Different Administrations and Elections</u>

During election years, some investors think they should speculate on which political party might win and change their investment strategy based on the outcome of the election. ***The chart below clearly reveals the best strategy.***



DJIA is the Dow Jones Industrial Average
Source: Charles Schwab

Conclusion

You are more likely to have a successful investment experience if you use the principles of evidence-based investing and the Nobel Prize-winning research that produced them.

Still, many investors do not consistently heed this advice. They can be fearful, greedy, or simply restless and impatient.

Living here in Colorado, I am reminded of the many hiking trails that lead to the summits of our mountains. Most of these trails were built long ago by people who knew the terrain well, and thousands of hikers successfully use these trails each year.

Still, established trails can be frustrating sometimes. There are always a few sections that go down for a short time or make turns that seem to go away from the summit.

Each year there are impatient hikers who leave established trails to take their own shortcut. Ask any search and rescue professional – it's a regrettable decision that often leads to trouble. The hikers get lost. The terrain becomes unpassable. They encounter obstacles that they didn't see or anticipate. Some get hurt or injured, or worse. Meanwhile, if they had just trusted the trail, they would have made it. They just needed to have patience.

As we face a turbulent election cycle, I recommend that investors review and recommit to executing the fundamentals. They set forth an established trail that will take you to the summit.

If you have questions about your savings program, your portfolio, or your long-term financial plan, please give me a call.

Thank you.

D. Austin Lewis

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