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LIFE BOAT DRILLS DEUX

One year ago, in a Bodnar Financial White Paper entitled *"Life Boat Drills, or, Why it's tough for humans to be successful investors"* I implored you, my dear clients, to pick up a Ticonderoga from your desk drawer and engage your brain in the rudimentary math of a stock market sell-off. On the day that I wrote that piece (May 20, 2013) the Dow Jones Industrial Average (DJI) was trading at 15,354 and you read how the average investor would react when the inevitable market correction of 10-20% occurred. Using a mid-point of 15% we discussed the psychology of a 2,303 point drop in the DJI, and the utter enthusiasm and excitement that would pour forth from the studios of CNBC and Bloomberg. With lifetime membership in the apocalypse du jour crowd, the main-stream media search each day (even if they need to help it along) for something akin to an O.J.-in-the-White-Bronco moment.

Well....just goes to show...what do I know? Once again I have proven that I'm about as clairvoyant as an Ouija Board. We've hit a few speed bumps of 5-6% downdrafts over the past 13-months, but as of this moment, the DJI reads 16,826 an increase of 1,472 points or approximately 9%.

Faced with a constant drumbeat of end of the world scenarios including US Government debt default, climate change and extreme weather, IRS scandals, "line in the sand" in Syria, high-frequency-trading, civil war in Iraq, Russians invading the Ukraine; any of these could easily have stampeded the market into a very normal 10% correction. Yet, the story we are left with is: *The Little Correction That Couldn't.*

Investing, by its very nature, requires us to submit ourselves to variables we can neither predict nor control. World events, government policies, interest rates, taxation, inflation and the business cycle are just some of the forces which may act upon our investments over time. If you spend the time, you can identify patterns in history which have served investors well over time.

Robert Caro, the biographer of LBJ, was famous for saying "The power of history is in the end the greatest power." The unknown is not the same thing as chaos. Remembering these trends and attributes will help all of us remain rational under uncertainty.

Unfortunately, the majority of investors do not remain rational under the uncertainty, and they waste great quantities of time and energy studying the variables which we readers of history have come to believe is random.

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Listed below are the SIX disciplines (3 temperaments & 3 regularly performed actions), which practiced together, will help the long-term, goal-focused investor achieve investment outcomes that are supportive of their financial plan – recall that a financial plan is NOT about economic forecasting, market timing, or beating the S&P500. Financial planning at Bodnar Financial is about helping clients _achieve their life goals with a sense of security._

Faith in the future is a governing temperamental quality of not only successful investors, but I am convinced it is necessary to live a full and meaningful life. I'm not sure how to go about proving this to you, but I'm convinced that it is impossible for anyone who is fundamentally fearful of the future to achieve long-term investment success. The investor who perceives the world as chaotic, fragile and forever on the brink of some ultimate catastrophe will always get scared out of the markets again and again – and usually near the panic low point.

> *If your goals have not changed, then do not change your plan; if your plan has not changed, do not change the portfolio.*

You have read it here before – _Optimism is historically the only realism_ – the only worldview that squares with the facts, and with the historical record. Each of you has seen this in your own lives, and the longer we live, the more obvious it becomes. And it isn't just technology – although the iPhone5 that I carry contains more computing power than powered the Apollo spacecraft that landed on the moon.

The joint life expectancy of a nonsmoking couple of average retirement age (62) is thirty years. Thirty years ago the Standard & Poor's 500-Stock Index was about 160. Its earnings were running at about $17, and its dividend was around $7.50. As I write, the Index is trading at 1,960. The consensus earnings estimate for 2014 is in the neighborhood of $120, and I'm guessing the dividend will end the year at about $38. Can you count – much less recall the details of all the disasters that have befallen this country and the world, just in those thirty years? Faith in the future is not optimism in spite of the facts, but because of them—*Optimism is historically the only realism.*

The second temperamental quality which seems to increase the chances of long-term investment success is ***patience.*** (I heard that collective groan – UGH, not patience!!) We live not in an age of enduring truth, but of late-breaking news. In a world of 24/7 news cycles, and the endless blather of talking heads pressuring us to do something smart and timely right now, it is becoming ever more difficult to stick to our long-term plans and portfolios. Portfolios that were created to fund your most important multi-decade goals should not be sidetracked by headline news. If your goals have not changed, then do not change your plan; if your plan has not changed, do not change the portfolio.

The third and last temperamental quality is ***discipline***. This may not at first glance appear much different from patience, but wait until the next time the market goes down 30% with every talking head you hear in the media extrapolating the current "crisis" right over the cliff. Patience is the ability to keep doing the right thing, but discipline is more about forbearance, or the capacity not to react – not to

do the wrong thing, most notably panicking out of the markets at a moment of maximum pessimism. As the late great Louis Rukeyser always said during apparent "crises": *Don't just do something; stand there.*

Now to the three regularly performed activities that I believe will carry you into the higher echelons of lifetime investors. These practices are simply ways of carrying out the temperamental qualities listed above: the principles dictate the practices, in the sense that beliefs always dictate behaviors.

The first practice is ***asset allocation*****, which simply refers to the percentage of equities versus bonds in your portfolio, on average, over your investing lifetime. This raw number – more than any other portfolio variable and perhaps, more than all the others combined—will likely dictate your lifetime investment return.

> *"All of us would be better investors if we just made fewer decisions."*
>
> 2002 Nobel Prize winner - --Dr. Daniel Kahneman

The long-term compound return of large-company stocks over the last roughly nine decades – with dividends reinvested – is close to ten percent annually. For small company stocks, it's approaching twelve percent, because of their obviously greater risk (more small companies fail) and volatility. The compound return of long-term high quality corporate bonds (interest reinvested) is just under six percent.

Net out from these nominal returns long-term inflation during this period of three percent, and you will discover the following: at seven and nine percent respectively, large and small company stocks have historically compounded at two to three times the three percent real return of quality bonds. In a nutshell, this tells you why the percentage of your portfolio allocated to equities versus bonds has historically been decisive. Of course, with this high percentage in equities, you now face the consuming impulse to panic-out of declining equities during the inevitable market corrections. Do you see why temperament is critical, and why we regularly run Life Boat Drills?*

The second practice is ***diversification*****, which to me is perhaps the ultimate expression of rationality under uncertainty. Within the equity asset classes, ought we to own large company or small company equities? Domestic/developed world equities or emerging markets? Actively managed funds or indexed funds/ETFs? Speaking only for myself, my answer is unequivocally YES – to all of the above. (The only thing I wouldn't own in bulk is individual stocks. Why? Because I am nowhere smart enough.)

Adequate diversification is summarized in the following: *I'll never own enough of any one thing to make a killing in it; I'll never own enough of any one thing to get killed by it.* I hold this formula to be beyond rationality under uncertainty: to me, it is uncertainty worn as a badge of honor.

**For those of you unfamiliar with Life Boat Drills – please visit our website at www.Bodnar.net > About Us > The Library >*Was 2012 the Best Year Ever? *No internet access? Contact our office and ask to be sent the May 2013 White Paper*

The third action, and the last of the six disciplines, is ***rebalancing***. Let's hypothesize that your plan leads you to invest equally in five different equity sectors: twenty percent of your capital in each.

A year later, you'll almost surely find that this mix has slipped out of whack: some of your portfolios will have outperformed others, such that they now contain more than twenty percent of your portfolio, whereas the relative laggards contain less than your twenty percent.

What most Americans will do, if anything at all, is to sell the laggards and put the money in the hot trends, thereby simultaneously selling low and buying high. There may be a more reliable formula for consistent underperformance, but if there is I've yet to discover it. Rebalancing causes us to sell off some of our positions in things that have had a successful run and to redeploy the capital into things which are relatively out of favor. Thus systematically over the years selling high and buying low.

There is a term for these six disciplines when practiced together....it's investing. And successful investing is more often about what you didn't do rather than the actions you took. I leave you with the words of 2002 Nobel Prize winner Dr. Daniel Kahneman (channeling his inner Louis Rukeyser): "All of us would be better investors if we just made fewer decisions." Amen Professor.

John Bodnar, CFP®, CIMA®

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**Diversification and asset allocation strategies do not assure profit or protect against loss.