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Bear Markets to Be Borne With Equanimity
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The holiday season is supposed to be about good cheer. Given the economic news, you might think investors would have plenty to be cheerful about. For example:

- Economic growth is strong. The Federal Reserve Bank of Philadelphia's Fourth Quarter 2018 Survey of Professional Forecasters projects real GDP growth of 2.7 percent for 2019, down just slightly from the forecast of 2.9 percent for 2018.
- Unemployment is at 3.7 percent, the lowest rate in 50 years.
- Inflation is moderate. The Philadelphia Fed's latest 2019 forecast is for an increase of 2.3 percent in the Consumer Price Index (CPI), down slightly from its forecast of 2.4 percent for 2018.
- Consumer sentiment (a leading indicator) is strong. The final December University of Michigan Consumer Sentiment Survey came in at 98.3, remaining near the highest levels we have seen over the past 18 years (despite the recent weakness in stocks). The last time the Consumer Sentiment Index was consistently above 90.0 for at least as long was 1997 through 2000, when it recorded a four-year average of 105.3.
- The November ISM (Institute of Supply Management) Non-Manufacturing Purchasing Managers' Index came in at 60.7 percent, 0.4 percentage point higher than the October reading of 60.3 percent — representing continued growth in the non-manufacturing sector and at a slightly faster rate. The six-month moving average of the index is at about its highest level in more than 20 years. The Non-Manufacturing Business Activity Index increased to 65.2 percent in November, 2.7 percentage points higher than the October reading of 62.5 percent, reflecting growth for the 112th consecutive month, at a faster rate.

The bottom line is nothing in the economic data indicates we are headed into a recession that could lead to a bear market (with the stock market being a leading indicator). While the current economic expansion is now 10 years old, expansions don't die of old age, as many seem to believe. For example, the Netherlands didn't have one between 1981 and 2008 and Australia's streak is currently at 27 years. They die either because geopolitical risks show up, or because the Fed tightens monetary policy, driving real rates to high levels to fight inflation. Today, the real rate on one-month Treasury bills is about zero. Even if the Fed were to raise rates three more times over the next 12 months (the market currently expects only one more rate hike in 2019), the real rate would still only be about 1 percent, which is about the historical average and certainly not indicative of a tight monetary policy that would cause a recession.

I mention the good news because it's easy to lose sight of the facts when for investors there has been little cheer. The S&P 500 Index dropped 579 points from its closing high of 2,930 on September 20 to finish at 2,351 on December 24, a price drop (not including the return from dividends) of 19.8 percent. From December 1 through December 24, the S&P 500 fell 409 points, a drop of 14.8 percent. Since 1926, we have had only 10 worse months — the worst was the 29.7 percent loss in September 1931 — and only two worse months in the last 78 years (October 1987's loss of 21.5 percent and October 2008's loss of 16.8 percent). With that said, large losses are not that unusual. For example, from 1948 through 2017, the Dow Jones Industrial Average (DJIA) fell at least 15 percent about once every three years — with the average duration being 275 days. It also fell by 20 percent or more about once every six years, with the average duration being 425 days.

What really has investors worried is whether this current drop will turn into a roaring bear market — defined as a drop of at least 20 percent. As you can see in the following table, over the last 100 years the DJIA has experienced 15 such drops, with an average loss of 38.7 percent and an average duration of 403 days.

Peak-to-Trough	Days	Maximum Drawdown
November 1919 – September 1921	455	-46.2%
October 1929 – July 1932	679	-86.3%
March 1937 – March 1938	272	-49.0%
November 1938 – April 1942	871	-41.2%
May 1946 – June 1949	767	-24.0%
December 1961 – July 1962	135	-27.1%
February 1966 – October 1966	168	-25.2%
December 1968 – May 1970	373	-35.9%
January 1973 – December 1974	483	-45.1%
September 1976 – February 1978	368	-26.9%
April 1981 – August 1982	328	-24.1%
August 1987 – October 1987	38	-36.1%
July 1990 – October 1990	61	-21.2%
January 2000 – October 2002	685	-37.8%
October 2007 – March 2009	355	-53.8%
October 2018 – Dec. 24, 2018	**55**	**-16.3%**
Average	**403**	**-38.7%**
Median	**368**	**-36.1%**

What makes such markets difficult to live through without panicking is that, on average, investors are highly risk averse. Nobel Prize winner in economics Richard Thaler, author of the book

"Misbehaving," has found that we tend to feel the pain of a loss twice as much as we feel the joy from an equal-sized gain. And that ratio increases with the size of the investment!

The research has found that losses even lead to heightened autonomic responses, compared to equivalent gains. Professors Guy Hochman and Eldad Yechiam of the Israel Institute of Technology studied the effect of losses on investors and noted that losses spurred higher physical responses, such as pupil dilation and increased heart rate. This was true even for people who weren't naturally averse to losses.

So, if your investments are causing you to feel stressed, do not feel bad about your anxiety. Your feelings are normal. However, the first step to addressing a problem is to admit its existence. Even if you have a well-thought-out plan that anticipated such declines, as the well-worn saying goes, all plans are great until the first shot is fired. Similarly, renowned philosopher Mike Tyson famously quipped that everyone's got a plan until they get punched in the mouth.

If you're feeling punched, it's normal. However, it may mean that you were overconfident in estimating your ability or willingness to take risk. If that's the case, a review of your plan is in order. A Monte Carlo simulation should be run to determine if you could meet your financial objectives with a less risky portfolio. It's better to admit the error now, and correct it, than to run the risk of much deeper losses that might lead to panicked selling and/or the failure of your financial plan.

Here are some further thoughts I hope are helpful.

Seeking to Avoid Pain

Because it's human nature to seek to avoid pain, the pain of bear markets and underperformance tends to cause investors to consider changing strategy. It's an all-too-human trait to want to believe that someone out there can protect us from bad things happening to our portfolio — despite the fact that the evidence shows no such person exists. However, before choosing a new strategy, you should be sure there is evidence to support your belief in why it will be more likely to help you achieve your goals. Consider the following evidence on three common alternative strategies: using actively managed funds, using hedge funds, and engaging in tactical asset allocation by managers/advisors.

- While the evidence on active management overall paints an abysmal picture, perhaps it's true that active managers can protect us from bear markets. To test this hypothesis, Vanguard studied the performance of active managers in bear markets, which they defined as a loss of at least 10 percent. The study, published in the Spring/Summer 2009 issue of Vanguard Investment Perspectives, covered the period from 1970 through 2008. The period included seven bear markets in the United States and six in Europe. Once adjusting for risk (exposure to different asset classes), Vanguard concluded that "whether an active manager is operating in a bear market, a bull market that precedes or follows it, or across longer-term market cycles, the combination of cost, security selection, and market-timing proves a difficult hurdle to overcome." The researchers also confirmed that past success in overcoming this hurdle does not ensure success in the future. Strike one.

- Over the past 10 calendar years the HFRX Global Hedge Fund Index lost 0.4 percent per year, underperforming every single major equity and bond asset class. The underperformance ranged from 1.6 percentage points when compared to the MSCI EAFE Value Index to as much as 9.5 percentage points when compared to U.S small-cap stocks. Compared to a balanced portfolio allocated 60 percent to the S&P 500 Index and 40 percent to the Barclays Government/Credit Bond Index, it underperformed every single year. Strike two.

- In his book "Investment Policy," Charles Ellis discussed a study of the performance of 100 pension plans that engaged in tactical asset allocation. Not one single plan, he reported, benefited from the effort. If pension plans, with their advantages of scale and their use of highly paid consultants, are unable to win this game, why do you think that you, or some advisor you hire, would be likely to succeed? Strike three.

Playing the Winner's Game

The evidence is clear that the strategy most likely to allow you to achieve your financial goals is one based on both:

- Historical evidence demonstrating that active management is a loser's game (it's possible to win, but the odds of doing so are so poor that it's not prudent to try).

- Certain asset classes and factors have provided premiums meeting all of the following criteria. They are: 1) persistent over long periods of time; 2) pervasive across sectors, countries, regions and even asset classes; 3) robust to various definitions; 4) survive transaction costs; and 5) have risk-based or behavioral explanations for their persistence into the future.

Because the evidence is strong for each of the factors to which we seek exposure in portfolios (market beta, size, value, momentum and quality/profitability) we can have a high degree of confidence that the premiums are likely (but not certain) to persist in the future. (It's uncertainty that leads one to conclude the prudent strategy is to diversify across as many factors as we can identify that meet all the criteria established.) However, risk aversion and the pain of losses leads to a problem known as myopic loss aversion — the tendency for even those with long investment horizons to focus on short-term results.

Investor Myopia

Over the almost 25 years that I have been an investment advisor, I've learned one of the greatest problems preventing so many investors from achieving their financial goals is that, when it comes to judging the performance of an investment strategy, they believe three years is a long time, five years is a very long time, and 10 years is an eternity. That leads them to abandon even the most well-thought-out plans. We observe this even with supposedly more sophisticated institutional investors, including those who employ highly sophisticated consultants, as they typically hire and fire managers and advisors based on the last three years' performance. As Michael Mauboussin, director of research at BlueMountain Capital Management, noted, this tendency "causes investors to often make the critical mistake of assuming that good outcomes are the result of good process and bad outcomes imply a bad process." On the other hand, financial economists know that for investment returns, 10 years can be nothing more than what they call "noise," a random outcome.

In recent years, it has been the poor performance of international stocks and U.S. value stocks (though internationally value has outperformed growth). That underperformance has resulted in investors experiencing the dreaded psychological condition known as tracking error regret, which occurs when your portfolio underperforms a popular index, such as the S&P 500. Regrettably, the twin problems of "relativism" (how the performance of your portfolio compares to that of your friends' and to popular benchmarks) and "recency" can conspire to lead investors to abandon even well-thought-out plans.

Relativism

Unfortunately, too many investors have entered what Vanguard founder John Bogle calls the "age of investment relativism." Investors' satisfaction or unhappiness (and by extension, the discipline required to stick with a strategy) is determined to a great degree by the performance of their portfolio relative to some index (an index that shouldn't be relevant to an investor who accepts the wisdom of diversification).

Relativism, sadly, can best be described as the triumph of emotion over wisdom and experience. The history of financial markets has demonstrated that today's trends are merely "noise" in the context of the long term. Bogle once quoted an anonymous portfolio manager, who warned: "Relativity worked well for Einstein, but it has no place in investing."

Before you consider changing strategy based on the results of such periods, consider the following data from Ken French's website.

- 15 years (1929-1943) U.S. Market Beta: -0.5 percent annualized
- 14 years (1969-1982) U.S. Market Beta: -0.8 percent annualized
- 13 years (2000-2012) U.S. Market Beta: -0.2 percent annualized

As you can see, we had three long periods where the U.S. market beta premium (the excess return of the stock market compared to U.S Treasury bills) was negative — investors took all the risks of equities while earning lower returns than they could have earned on risk-free one-month Treasury bills. That is without even considering the costs of implementing an equity strategy. Thus, actual results would have been even worse. Note also that the three periods make up a 42 of the 90 years from 1929 through 2018 — that's 47 percent of the total period. Would you have abandoned your belief in equity investing after such a period and stuck with Treasury bills? You should not have, because equities are risky and investors require a large premium for taking that risk.

Again using Ken French's data, let's look at how the size and value premiums performed during those same three periods. Returns are annualized.

- 15 years (1929-1943) U.S. Market Beta: -0.5 percent; Size: 4.9 percent; Value: 5.0 percent

- 14 years (1969-1982) U.S. Market Beta: -0.8 percent; Size: 2.4 percent; Value: 5.5 percent
- 13 years (2000-2012) U.S. Market Beta: -0.2 percent; Size: 4.4 percent; Value: 5.1 percent

In each case, the size and value factors (the excess return of small companies over large companies and the excess return of value companies over growth companies) provided large premiums during long periods when market beta was negative. Of course, that isn't a guarantee this will always be the case. However, it does demonstrate the historical and potential benefits of diversifying across unique sources of risk. That is exactly why we diversify across asset classes/factors—our crystal ball, like all crystal balls, is always cloudy. And diversification is like insurance; insuring against having all our eggs in one risky basket.

Here's another important point. When an asset class or factor has performed poorly, that generally means it has gotten cheaper and, thus, now has higher expected returns. It's the reason why we tend to see reversion to the mean of long-term returns. Thus, before you abandon a well-thought-out plan due to poor recent performance, consider the following:

Do You Want to Buy What's Cheap or Expensive?

You have a choice to invest in asset class A, which has a one-year forward-looking price-to-earnings (P/E) ratio of 10.6, or asset class B, with a P/E of 15.7. The P/E of B is 48 percent higher than it is for A. You then look at another valuation metric, the price-to-book (P/B) ratio. You find that A has a P/B of 1.1 while B has a P/B of 2.5. The P/B of B is 2.3 times that of A. For investors focusing on dividend yields, the yield on A is 2.9 percent versus 1.9 percent for B.

A is cheaper by all three metrics. However, perhaps B has better growth prospects? The weighted average historic three-year earnings growth of A was 16.1 percent, 45 percent higher than the 11.1 percent growth for B. The weighted average estimated three-year to five-year growth of earnings for A is 15.7 percent, 21 percent higher than the 13.0 percent estimated growth for B.

Comparing the P/E relative to expected earnings growth (the PEG ratio), we find that the forward-looking PEG for A is 0.68 (10.6/15.7) versus 1.21 for B (15.7/13.0). Relative to forecasted growth in earnings, B is trading 1.78 times higher.

Here are some other interesting facts.

- As a group, year-over-year growth in real gross domestic product (GDP) for the countries in A was 5 percent versus 3 percent for B.
- The countries in asset class A make up about 28 percent of global GDP, higher than the 25 percent share for B. However, A makes up not much more than 10 percent of global market capitalization, while B makes up more than half.

By now you may have figured out that A is emerging market stocks, as represented by the S&P Emerging BMI, and B is the S&P 500 Index. All data is from S&P Dow Jones Indices' Indexology® Blog.

We can add one more valuation metric, the cyclically adjusted price-to-earnings (CAPE 10) ratio, which is as good a predictor of long-term *real* returns as we have. CAPE 10 ratios as of the end of October 2018 for emerging markets and for the S&P 500 Index translate into forward-looking real-return forecasts of 6.8 percent and just 3.4 percent, respectively.

Unfortunately, investors are also subject to recency bias — allowing more recent returns to dominate their decision-making. From 2008 through November 2018, the S&P 500 Index returned 8.3 percent per year, providing a total return of 138 percent. During the same period, the MSCI Emerging Markets Index returned just 0.7 percent a year, providing a total return of just 8 percent. It managed to underperform the S&P 500 Index by 7.6 percentage points per year and posted a total return underperformance gap of 130 percentage points.

Compounding the problem was that not only were investors earning much lower returns from emerging market stocks, but also that they were experiencing much greater volatility. While the annual standard deviation of the S&P 500 Index was about 15 percent per year, the MSCI Emerging Markets Index's standard deviation was about 22 percent per year. Not exactly a great combination — lower returns with 50 percent greater volatility. What's to like?

Further compounding the problem is that investors tend to have short memories (especially after periods of losses). For example, it wasn't long ago that investors were piling into emerging market equities due to their strong performance. For the five-year period from 2003 through 2007, while the S&P 500 Index provided a total return of 83 percent, the MSCI Emerging Markets Index returned 391 percent. Emerging market value stocks did even better, as Dimensional data shows that its Emerging Market Value Index returned 521 percent. How quickly investors forget!

Before moving on, it's worth noting the following forecast on international equities, which as we discussed have underperformed by a wide margin over the past decade, perhaps leading many investors to abandon them. Vanguard now expects international stocks to outperform U.S. stocks over the next 10 years by a margin of 3 percent to 3.5 percent. Specifically, Vanguard expects a 4 percent annualized return for the U.S. stock market over the next decade, versus 7 percent to 7.5 percent for international equities. The expected performance gap is mainly driven by equity market valuations in the United States being much higher than for developed international markets (plus the U.S. economy being much further along in terms of its monetary tightening).

We have another important issue to discuss.

Diversification Means Being Uncomfortable

Adam Butler of ReSolve Asset Management once offered the following observation: "Investing provides a premium because it is uncomfortable. The more experience I accumulate in this business, the more I have come to believe that the returns an investor can expect to achieve are directly proportional to the amount of discomfort that they are willing to tolerate."

Investors face a choice. They can either own a traditional market-like portfolio, which has the vast majority of its risk concentrated in the single factor of market beta (for a typical 60 percent equity/40 percent bond portfolio, it's almost 90 percent), or they can choose to diversify across as many unique sources of risk and return that have been identified and meet all the criteria we established earlier (persistence, pervasiveness, robustness, implementability and with intuitive explanations for their persistence). The first path is the comfortable one in the sense that your portfolio will not cause any tracking error regret — you won't be underperforming popular benchmarks that are reported on daily by the financial media. On the other hand, the traditional market-like strategy will likely be highly uncomfortable during periods like 1973-74, 2000-02 and 2008, when the single-factor (market beta) that dominates such portfolios' risk suffers from severe bear markets.

Failing conventionally is always easier than failing unconventionally (misery loves company). Based on the historical mean and historical volatility, the market beta premium should be expected to be negative about 9 percent of the time over 10-year periods. However, we should expect more frequent failures in the future because current valuations are much higher than historical valuations. Thus, we should expect a smaller premium. From 1927 through 2018, the market beta premium was 8.5 percent. Most financial economists expect it to be much smaller going forward, perhaps half as much. A smaller premium with the same volatility means greater odds of negative returns.

The second path, diversification, is more likely to lead to successfully achieving goals. However, it does mean having to live with the fact that your portfolio will perform very differently than traditional portfolios, creating the risk of tracking error regret. In that sense, diversification is not a free lunch. It means living through uncomfortable periods, even long ones. And, during periods of failure, it means failing unconventionally, which is much harder to deal with.

Given that you must accept you will have to live through uncomfortable times whichever path you choose, it seems logical that you should pursue the path that gives you the highest odds of achieving your goals. And that is choosing the more efficient portfolio, the more diversified one, and saying, "I don't give a damn about tracking error regret because relativism has no place in investing."

Let's move on to discussing what happens if you do decide to sell equities.

If I Sell Now, Then What?

In case the latest market crash is tempting you to sell now and wait for safer times, remember that to benefit from market timing you have to be right twice, not once. I hope the following explanation helps you to decide on the right strategy.

If you go to the beach to ride the waves and you want to know if it's safe, you simply look to the lifeguard stand. If the flag is green, it's safe. If it's red, the ride might be fun, but it's also too dangerous to take a chance. For many investors today, the market looks too dangerous. So, they don't want to buy, or they decide to sell. Here's the problem. While the surfer can wait a day or two for the ocean to calm down, there is never a green flag that will let you know that it's safe to invest. You might think that is the case (as many investors did in the late 1990s), but it never is. Recall the litany of problems the markets faced from March 9, 2009 (when the bear market ended) all the way through 2017. There was never a green light letting you know it was safe. It was red the entire time. And for much of that period (from 2013 onward), you had highly regarded market gurus such as Jeremy Grantham warning that the market was massively overvalued. Yet, the market ignored those warnings and provided returns well above the historical average. So, if you decide to sell, you are virtually doomed to fail as you wait for the next green flag. Even worse is what happened to some investors who only thought they saw a green flag.

Consider an investor who, after watching the S&P 500 Index crash from about 1,450 in February 2007 all the way to 752 on Nov. 20, 2008, finally throws in the towel. He cannot take the losses any longer. He is worn out by the wave of bad news. So, he decides to sell. However, he knows there is a problem. With interest rates at their current level, there was no way he could achieve his financial goals without taking risks. And he certainly did not want to buy riskier fixed income investments (such as high-yield corporate bonds, preferred stocks or emerging market bonds), having watched how poorly they were performing. The mistake of confusing yield with return was one he was not going to make. Thus, he designs a strategy to get back in. He will wait until next year to see if the market recovers. By Jan. 6, 2009, the S&P 500 had risen almost 25 percent to 935. Of course, he had missed that rally while he waited for that green flag. But now he feels it's once again safe to buy. Unfortunately, by March 9, 2009, the market had dropped back all the way to 677. So, now he sells again. How likely do you think it is that he would ever find the courage to buy again? That is the essence of the problem.

Here's some further evidence that might help you avoid panicked selling. As mentioned earlier, there have been only two months in the last 78 years when the S&P 500 Index fell more than 15 percent — October 1987's loss of 21.5 percent and October 2008's loss of 16.8 percent. How did the market perform after those losses? While November 1987 tested investors with a further loss of 8.2 percent, the following 12-month return (November through October) was 14.7 percent. And while November 2008 also tested investors with a further loss of 7.2 percent, the following 12-month return was 9.8 percent.

Over the last 78 years, we have also experienced four quarters in which the S&P 500 lost more than the 20 percent — the four quarters ending September 1974 (-25.2 percent), December 1987 (-22.6 percent), December 2008 (-21.9 percent) and June 1962 (-20.6 percent). Over the next 12 months, returns ranged from 17 percent to 38 percent (averaging 28 percent); over the next 36 months, returns ranged from 49 percent to 73 percent (averaging 60 percent); and over the next 60 months, returns ranged from 95 percent to 128 percent (averaging 112 percent).

Let's try to summarize what we have learned.

Five Lessons to Be Learned

First, it's important to understand that bear markets are a feature of the stock market. Without them there would be no risk and, therefore, no equity risk premium. As investors we would not like that. If we were to look back at every other market decline, we would see there were investors who thought the only light at the end of the tunnel was the proverbial headlights of a truck coming the other way. In each instance, it turned out that wasn't the case. And it's likely that isn't the case now either. In other words, every *past* decline looks like an opportunity; every *current* decline feels like risk.

When the stock market is meeting our best expectations, thinking about the market's inevitable up and down cycles and the benefits of a disciplined approach sounds reasonable, even easy. Yet, when the market goes down, it often feels different, maybe difficult. That is explained by the tug of war between our emotions and our reasoning. Which side wins? French philosopher Blaise Pascal declared: "All of our reasoning ends in surrender to feeling." Our job as your advisor is to prove Pascal wrong!

It's why we write down our reasoning in an investment policy statement (IPS), tied to your specific goals. That way, when emotions grow strong and threaten to overrule reason, we can help reason prevail. For instance, your IPS includes data about past downturns, which are expected to occur periodically. Reason can remind us that this current market correction is expected, and your financial plan is designed with this in mind.

Second, your investment strategy should be based on evidence, data and logic—the criteria laid out above. And you should not be swayed to change your strategy unless you are convinced the underlying assumptions on which your strategy was based have changed. There is nothing in today's environment that should lead you to conclude your assumptions no longer hold.

Third, there are always things to worry about. It's why during bull markets stocks are said to climb a wall of worry. Thus, it's important to remember that while you might be worried about such issues as still-high U.S. equity valuations (the Shiller CAPE 10 remains about 26, though it is well down from its January 2018 level of 33.3), a slight inversion in the yield curve, the potential of a major trade war, and the shutdown of at least part of our government, you can be certain that the sophisticated institutional investors now accounting for about 90 percent or more of trading volume, and thus are setting prices, are also well aware of those issues. Thus, the risks are already incorporated into prices. That means that unless the outcomes are worse than expected, markets should not fall further. Remember, it doesn't matter whether news is good or bad, only whether it is better or worse than already expected. In addition, as I pointed out to start, the news on the economic front is good. What's more, fiscal policy is very loose (with a record deficit) and monetary policy is far from tight. Thus, there is little reason to expect a recession any time in the near future.

Fourth, don't make the mistake of confusing strategy with outcome. "Fooled by Randomness" author Nassim Nicholas Taleb had the following to say on confusing strategy with outcome: "One cannot judge a performance in any given field by the results, but by the costs of the alternative (that is, if history played out in a different way). Such substitute courses of events are called alternative histories. Clearly the quality of a decision cannot be solely judged based on its outcome, but such a point seems to be voiced only by people who fail (those who succeed attribute their success to the quality of their decision)."

Unfortunately, in investing predicting results is notoriously difficult. Thus, a strategy should be judged in terms of its quality and prudence before, not after, its outcome is known.

Fifth, I've always believed that the greatest anomaly in finance is that while investors idolize Warren Buffett, they not only fail to follow his advice but often do exactly the opposite of what he recommends. That is what led me to write "Think, Act and Invest Like Warren Buffett." Let's consider the following advice offered by the "Oracle of Omaha" in his 2004 Berkshire Hathaway shareholder letter:

"Over the 35 years, American business has delivered terrific results. It should therefore have been easy for investors to earn juicy returns: All they had to do was piggyback Corporate America in a diversified, low-expense way. An index fund that they never touched would have done the job. Instead many investors have had experiences ranging from mediocre to disastrous. There have been three primary causes: first, high costs, usually because investors traded excessively or spent far too much on investment management; second, portfolio decisions based on tips and fads rather than on thoughtful, quantified evaluation of businesses; and third, a start-and-stop approach to the market marked by untimely entries (after an advance has been long underway) and exits (after periods of stagnation or decline). Investors should remember that excitement and expenses are their enemies. And if they insist on trying to time their participation in equities, they should try to be fearful when others are greedy and greedy only when others are fearful."

Simple, but Not Easy

The above observation is perhaps why Buffett has stated that investing is simple, but not easy. The simple part is that the winning strategy is to act like the lowly postage stamp that adheres to its letter until it reaches its destination. Investors should stick to their asset allocation until they reach their financial goals. This understanding allowed Buffett to ignore all the critics who criticized him for his "outdated" value strategy during the dot-com boom of the late 1990s, when growth stocks far outperformed value stocks. He didn't abandon his beliefs then (and was rewarded over the next decade when value dramatically outperformed), and I'm confident he hasn't abandoned them now.

The reason investing is not easy is that it is difficult for most individuals to control their emotions — emotions of greed and envy in bull markets and fear and panic in bear markets. In fact, bear markets are the mechanism that serves to transfer assets from those with weaker stomachs and without investment plans to those with stronger stomachs and well-thought-out plans — with the anticipation of bear markets built in — as well as the discipline to adhere to those plans.

Are you following Buffett's advice? Let's see:

- Your investment methodology has a focus on low costs (both expenses and taxes). Check!
- Your investment methodology is based on academic research and facts, not opinions (Buffett advises you to ignore all market forecasts). Check!
- Your investment plan is built around a disciplined approach, not market timing. Check!
- Buffett's advice to be greedy when others are fearful is accomplished by disciplined rebalancing (while taking advantage of loss-harvesting opportunities). Check!

Summary

The bottom line is that our recommendation will continue to be the same — buy, hold and rebalance — because that is what the evidence demonstrates is the most likely way to achieve your goals. Doing so in the face of so much uncertainty, and the stress created by bear markets, is what makes being a successful investor so difficult, despite how simple the winning strategy is. The inability to control one's emotions in the face of uncertainty is why so few investors earn market rates of return and thus fail to achieve their objectives.

To help you keep things in perspective, and not focused solely on negative news, it's worth noting three pieces of information related to markets. The first is that the yield on the 10-year Treasury bond has fallen from a high of 3.24 percent on Nov. 8 to 2.77 percent on Dec. 24. The second is that the Fed has signaled to the market that it has lowered expectations for further interest rate increases. The third is that China announced that on Jan. 3, 2019 it will lower tariffs on 700 goods — signaling progress on reducing the risks of a trade war.

Finally, it's critical to take the long view, avoiding myopic loss aversion. We have lived through 15 serious bear markets over the past 100 years. While each one was caused by unique circumstances, which leads many to believe that this time it's different, there really is nothing new in investing, just the investment history you don't know. Investors who have remained disciplined have been rewarded for their patience. The key to having patience is to be sure you have not taken more risk than you have the ability or willingness to assume. One way to avoid making that mistake is to not take on more risk than you need to. Again, running an updated Monte Carlo simulation can help determine if that is the case.