"Carnage or Correction?"

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financial guidance for life

Staying with Principles that Work

Roughly one month ago, the S&P 500 Index was just a few points away from its all-time high. As of today the market has officially breached "correction" status by falling 10% below its high, if only briefly, so far this morning. To say the least, this market behavior is disconcerting and can profoundly influence our emotions. So, we want to remind you of some key principles about how markets work and how we manage money on your behalf to keep you on track to attaining your goals.

1. **Attempting to play short-term market moves can be self-destructive.** There is a vast body of research that substantiates this very point. The financial media may tempt you to do otherwise, but the market timing road typically leads to higher costs, missed opportunities, and in many cases, greater losses. This behavior will typically create a drag on the performance you would have otherwise achieved over the long run had you stayed the course set out by your investment strategy and financial plan.
2. **You have to take risk to achieve your goals.** Markets compensate investors for taking risk, not sitting on cash. Stocks are riskier than bonds which are riskier than cash. Accordingly, the long-term returns for stocks are higher than bonds, which in turn, have returns higher than cash. In the short-run, market returns are driven by market participants' perceptions of and attitudes toward risk, not the long-term return-generating process of the economy and markets. If you are tempted to bet on predictions of changing perceptions, refer to #1 above.
3. **How you take risk matters**. Wealthcare Capital Management offers alternative investment approaches for this reason. Using an investment strategy that matches your beliefs and gives you confidence that you will be successful in the long run is essential to staying the course during volatile times. We believe in goals-connected, risk-managed, cost-effective investment approaches. Our flagship Pure Gamma strategy, which we have made available to clients since 2008, is the purest form of low-cost, goals-connected investing available. By design, it helps offset equity market risk through the use of a pure Treasury portfolio using 7 to 10-year maturities. This Treasury portfolio is up over 5% in the last month. It acts like a buffer when equity markets move downward.
4. **How you use risk matters**. Yes, you have to take risk to achieve your goals, and how you take risk in the markets matter. However, it is how you use risk to achieve your goals that is most central to how we serve you. This is captured in our patented Comfort Zone® which reflects the essence of goals-connected investing. Rather than reacting emotionally to a market sell-off, a goals-based approach allows us to first take a look at how market movement may be affecting your goals, and then make intelligent adjustments to keep you and your financial plan in the Comfort Zone.

Now, a few comments on the recent market behavior.

The Observer Effect

In science, the Observer Effect refers to the impact the act of observation has on that which is being observed. A common example is checking your tire pressure. You can't measure it without letting out some air. Applying this to crowd behavior, if enough people came by to check your tire pressure, you would eventually end up with a flat tire. There is nothing inherently wrong with the tire. The flat is caused by the people acting on it. Once you refill it with air, your car will travel just fine.

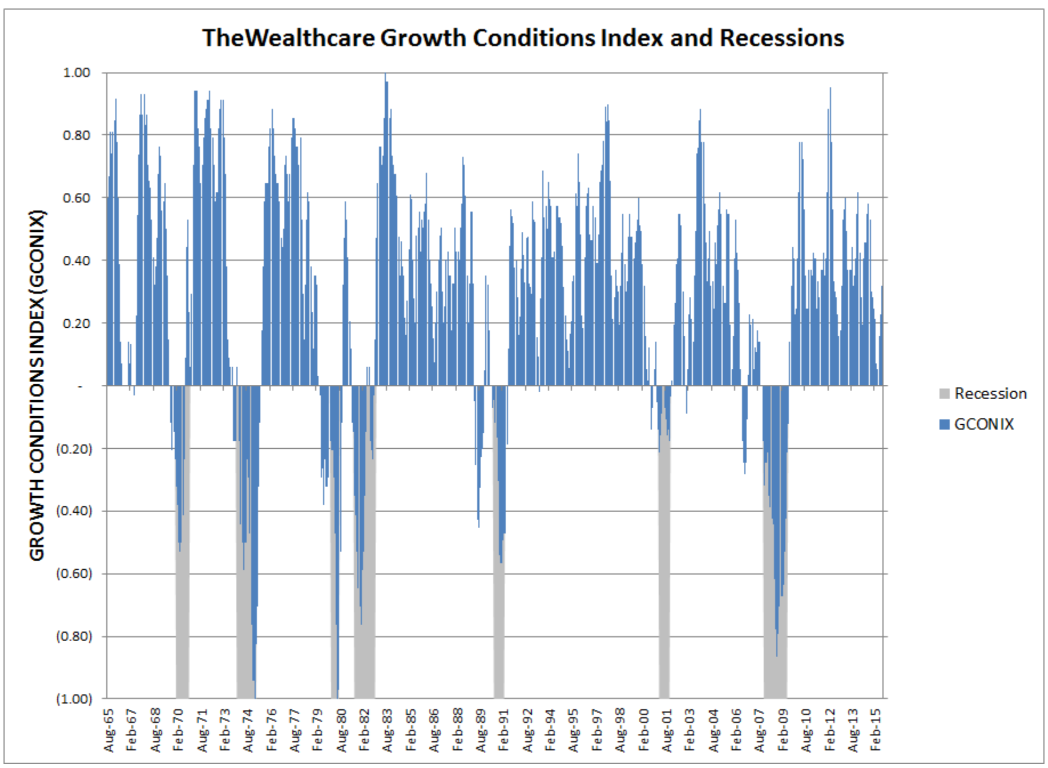
Markets are the personification of crowd behavior, with bull and bear markets often made more extreme by the echo chamber of market pundits, and the financial news media reporting after the initial market move. This morning, Bloomberg has been asking the question "Carnage or correction?" of various market pundits, as the Dow Jones Industrial Average has fallen another 600 points. About a month ago, the S&P 500 Index was within a couple points of its all-time high and is now down about 7.5% as I write. Fundamentals do not change so fast, but people's perceptions of fundamentals and attitudes toward market risk do. When market participants collectively act on these changing perceptions, we get market moves like the one we are experiencing now.

So let's ask the question, is there something inherently wrong with the underlying economy that justifies the correction, or is it more like the example above of too many people checking the tire pressure? We have had a lot of disconcerting news over the past several months – China's slowing growth, China's currency devaluation, Puerto Rico's debt default, Greece's near exit from the Eurozone, and the commodity markets have fallen with oil prices at levels not seen since the last financial crisis in 2009. Sounds pretty bad.

The thing is, slower growth in China has been a staple of the past several years. The currency devaluation is somewhat of a surprise, but in hindsight, it is less of a surprise given China's slower growth. The renminbi has only fallen by about 3% versus the dollar. Even after the devaluation, the renminbi has appreciated by about 30% since 2005 and is more than 40% undervalued using the Big Mac Purchasing Power Parity Index we referenced in our prior article on Greece and the Euro. The debt problems of both Greece and Puerto Rico have also been known for years. Finally, while commodity markets have been signaling slower demand growth for some time, particularly emanating from China, the oil price collapse has been supply-led by fracking-based production in the U.S. and additional supply from the Middle East.

What has the economy been doing through all this? Rather than quote the recent growth rates or the latest economic statistics, we have constructed a Growth Conditions Index (GCONIX), which captures 20 key variables that tend to lead or be coincident with economic activity. We will publish on it in more detail in another article, but I'm sharing it with you today, given all the turmoil, so you can see what it has been saying for yourself.

The GCONIX Index can range from 100% positive to 100% negative, based on whether each component of the Index is rising or falling. It is not intended to measure the level of growth, but the *breadth* of growth. If 10 of the GCONIX variables are rising and 10 are falling, it would have a reading of zero – or neutral. The chart below shows the GCONIX readings going back to 1965. The GCONIX averages around a 30% positive reading. The most recent measure is +33% for August with 15 of 20 indicators reported.



As you can see, GCONIX tends to lead and be coincident with recession. It is giving no recession signal at this time and has generally been positive throughout the bull market since late 2009.

As of right now, the market sell-off appears to be the result of the Observer Effect, a valuation and sentiment-based correction, but not because of something being inherently wrong with the economy that we can measure. It may be time to pump up that tire and head off to your next destination… a buying opportunity that will help you get closer to your goals. We will see, and we will keep you posted as to any meaningful change in this GCONIX.

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