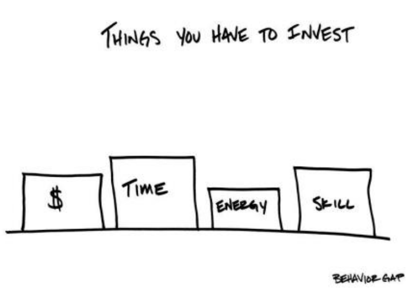
PITZL FINANCIAL

YOUR PERSONAL BOARDROOM

SUMMER 2017 NEWSLETTER

- **The Calm State of Equity Markets:** The first half of this year has featured the calmest markets in generations. History reminds us that will not last forever.
- **Q2 Market Review:** The second quarter of 2017 was much like the first; muted volatility, low interest rates, and markets continued to steadily rise.
- **Take More Risk in Life, Less in Investing:** The BAM Alliance's Tim Maurer explains that the regrets people have on their death bed are almost exclusively about risks they did not take in life, not the risks they did not take in their portfolios.



"THAT MEN DO NOT LEARN VERY MUCH FROM THE LESSONS OF HISTORY IS THE MOST IMPORTANT OF ALL THE LESSONS OF HISTORY." – ALDOUS HUXLEY

After the constant chaos and turmoil of the presidential election cycle in 2016, hard feelings and volatile headlines persist.

In the realm of global politics, we saw France elect a new President, a seismic shift in the seats of Parliament in Britain, continued conflict in the middle east, rising conflict in the far east with North Korea, and never-ending drama surrounding Russia, health care and taxes in the US.

We certainly have no shortage of talking points in the world today!

Despite all this, the second quarter of 2017 was quite similar to the first for global stock markets – positive, and pretty boring. There was very little in the way of significant market swings, as US and foreign markets kept inching their way upward.

Similarly, there was little in the way of surprising economic news this quarter. In a well-advertised move, the Fed raised interest rates again in June by 0.25%. The current 4.4% unemployment rate remains well below the historical average of 5.8%. And inflation remains under 2%.

The lessons of history warn us about complacency, overconfidence, and the power of recency bias. What we *feel* based on recent experience can betray us, often in very expensive ways.

When it feels like risk is leaving the market (low volatility, lack of significant declines), other risks are rising, not the least of which is the risk of increasing your risk tolerance!

As Warren Buffett has preached for decades, "be fearful when others are greedy, and greedy when others are fearful."

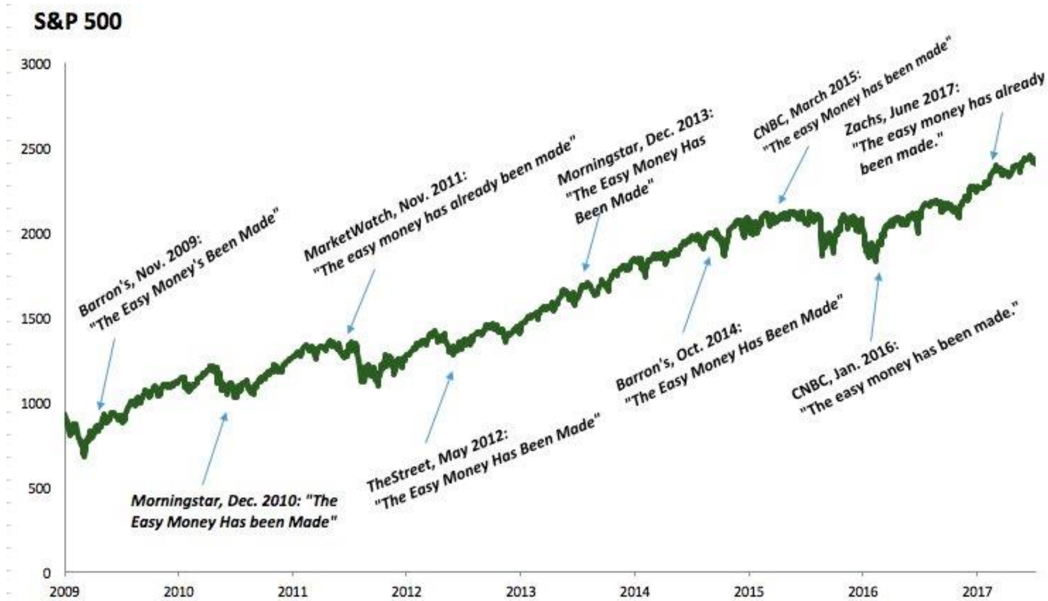
This mild volatility will not continue forever, and it is impossible to predict when that will shift. However, market participants are shifting into riskier assets, and traders are reducing their "short" exposure as volatility levels remain low.

As we discuss later in this newsletter, the risk profile of your portfolio is where it is for a reason, prudently designed not just based on your willingness to take risk, but based on your need and ability to take risk as well.

This month also marks the 3rd anniversary of Pitzl Financial. We have added two terrific new staff members to our team in 2017, Ann and Amanda. And early this year, we passed $100 million in assets under management. The past three years have been a terrific ride, and we thank you for being a part of it!

Q2 Market Review

"In the business world, the rearview mirror is always clearer than the windshield" – Warren Buffett



The chart above was captured from a tweet by financial writer, Morgan Housel.

The second quarter continued in a very similar manner as the first. Global stock markets continued to rise, while overall market volatility remained incredibly low.

The primary measure of volatility in the US markets, the VIX index, recently fell to its lowest level since 1993. In the financial realm, the VIX is also considered a measure of "fear" in the markets. Put another way, the overall market is extremely optimistic today.

After a year (2016) in which value stocks dominated growth stocks by a wide margin, the roles have reversed in US markets over the first half of the year, with growth stocks outpacing value. However, recent weeks has started to show signs of a shift. Whether that takes hold remains to be seen. Fundamentally speaking, earnings growth in the S&P Value index is expected to be nearly twice the rate of that of the S&P Growth index, and the valuations of the Value index are far more reasonable compared with historical averages.

Technology stocks are by far the leading sector of 2017 in the US, and recently hit all-time highs, with Amazon, Google, Facebook and Apple being the largest contributors to S&P 500 performance. However, it is notable that the prior all-time high for the S&P Technology index was over 17 years ago, in March of the year 2000!

Foreign markets are outperforming domestic markets for the first half of the year as well, with emerging markets even outpacing the gains in the technology sector.

But arguably, the factor that had the greatest impact on the market was the sharp decline in oil prices. The spot price dropped from $50.54 per barrel to $43.24 per barrel (a drop of more than 14 percent for the quarter), according to the U.S. Energy Information Administration. The change in price is likely due to excess oil supply, especially in the United States, where the number of oil rigs has increased for 22 consecutive weeks.

These lower oil prices have had the effect of a tax cut for consumers, which helps explain the strong performance of equities in the second quarter. U.S. equities returned 3.1%, developed foreign markets returned 6.1% and emerging markets returned 6.3%.

Lower oil prices can also mean lower inflation. Indeed, we see the market today forecasting lower inflation than it was three months ago. Lower inflation means that prices for goods and services will rise at a slower rate, but it also translates to lower nominal bond yields and interest rates.

On the whole, portfolios are doing exactly what they are supposed to be doing based on each respective risk profile, and continue to be well positioned moving forward. We are consistently monitoring the allocations and taking advantage of any rebalancing opportunities that present themselves. Toward the end of last year, that meant trimming from small and value stocks to buy bonds and foreign stocks. Currently, emerging markets and small foreign stocks are pressing the limits of their tolerance bands.

The rest of the summer promises continued political volatility, and markets may follow suit depending on what happens (if anything) with foreign policy, health care and tax legislation. We have had a very quiet year thus far, in that we have not experienced much in the way of downside volatility. Most people are very surprised by the rise in markets since last November, and we have been trimming those gains as necessary to keep things in balance.

Regardless of the direction markets take, we will continue to employ an academic-driven, evidence-based approach to managing your portfolio, which includes a plan of action that gives you the best odds of long-term investing success under a wide variety of market scenarios.

Take More Risk in Life, and Less in Investing

By: Tim Maurer, Director of Personal Finance for the BAM Alliance

"I just really wish I'd taken more risk in my investment portfolio," said no-one-ever on their deathbed.

That quote may seem like an odd observation, unless you consider the fact that I had the privilege of spending a couple days recently with life planning luminary George Kinder. Among other benefits, I was able to reacquaint myself with his famous three questions, elegantly designed to progressively point us toward the stuff of life that is the most important to us.

The last of his three questions invites us to explore what benchmark life experiences we would leave unaccomplished if we only had one day left on this Earth. And as you may suspect, even in a room filled with financial planners, achieving a more aggressive portfolio posture was, perhaps, the farthest from anyone's mind.

Meanwhile, most of the items that people did list represented experiences (not things) that, individually, were outside of their to-date unarticulated–but now evident–comfort zones.

Participants almost universally wished they'd have taken more risks in life–personally, educationally, relationally, experientially, professionally and vocationally.

Similarly, those most meaningful experiences they had enjoyed thus far in life were the ones that pushed the boundaries of their comfort zones, expanding their personal risk tolerance.

But what about financial risk tolerance?

It's now been well established that humans generally make poor investment decisions. The field of behavioral finance and economics has helped explain why:

- The pain of loss is twice as powerful as the joy of gain.
- We're even more risk averse than we think.

Furthermore, we only have so much risk tolerance in life to spend.

Yes, we each have a unique tolerance for risk, but regardless of how full our risk reservoir is, it is still an exhaustible resource. Therefore, the more risk you're taking in your portfolio–the more volatility that you are enduring and the more resolve you're expending to stay the course–the less risk you have to spend on the rest of your life.

There are those in my field who've made it their life's work to convince investors of the benefits of risk-taking in investing. And to be clear, those benefits have proven, historically, to be real. Those who take more risk in investing–strategically, mind you, not haphazardly–may justifiably expect to receive greater rewards from their investment portfolio over the long-term.

But at what cost? How much risk tolerance did you have to expend to endure losing at least half the value of your aggressive, well-diversified all-equity portfolio during the worst of the financial crisis? How much sleep lost? How many more meaningful life experiences did you pass on while you were exhausting your resolve to stay the proverbial course?

And for what benefit? Assuming you didn't do what studies suggest we're prone to do–bail out at the worst possible time, thereby eliminating any benefit whatsoever to the white-knuckle ride–you may have made more money.
But can you get the best of both worlds? All-equity returns with less risk? Historically, at least, the answer is yes.

Thanks especially to the groundbreaking work of economists Eugene Fama and Kenneth French of Dimensional Fund Advisors (and the number-crunching of my colleagues, Larry Swedroe and Kevin Grogan at BAM), we find evidence that an optimally diversified portfolio with only 60% exposure to stock volatility has enjoyed returns nearly equal to the 100% stock S&P 500 index (going all the way back to 1927).

But with 40% in stabilizing short-term government bonds, this simple portfolio has required less of an expenditure in personal risk tolerance because it has endured meaningfully less volatility than the all-equity index.

So, how do you want to spend your tolerance for risk? Glued to every market update, stressed through every downturn, fighting the temptation to capitulate at the bottom?

Or pursuing the hopes, dreams and goals in life that bring the deeper meaning we seek?