



THOUGHT FOR THE WEEK

Becoming Comfortable with Uncomfortable Investments

SYNOPSIS

- The adage to “buy low and sell high” sounds like an obvious path to building a large nest egg.
- The problem is that executing such a strategy is extremely difficult to pull off on a consistent basis.
- Those investors who can become comfortable with uncomfortable investments should do better over time.

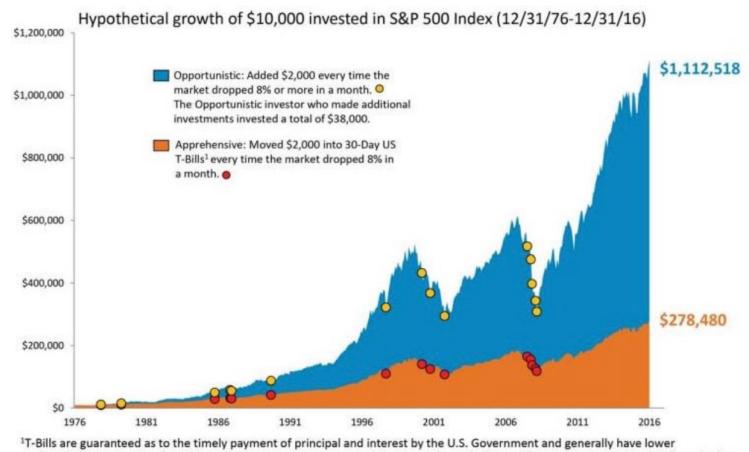
BUY LOW, SELL HIGH

The adage to “buy low and sell high” sounds like an obvious path to building a large nest egg. The premise is as simple as it gets. All that is required is to buy stocks cheap, sell them when they become expensive, and repeat until rich.

The problem is that executing such a strategy is extremely difficult to pull off on a consistent basis. Knowing when a stock is cheap or expensive requires expert-level skills in accounting, finance, and valuation techniques along with a thorough understanding of an investment’s competitive landscape.

The best stock pickers spend years in school and cut their teeth on far more losers than winners as they fine tune their analytical processes. They then compete with other stock pickers armed with a similar toolkit, so they must also have access to superior information or see something that their competition is missing to profit over the long run.

Therefore, I find this proverbial advice to be useless because of the difficulty in implementation, but that does not mean that investors should wing it or avoid stock ownership altogether. In fact, the following chart highlights an investment strategy that any investor can execute.



¹T-Bills are guaranteed as to the timely payment of principal and interest by the U.S. Government and generally have lower risk-and-return than bonds and equity. Equity investments are subject to market volatility and have greater risk than T-Bills and other cash investments.

Past performance is not a guarantee of future results. The performance shown above is index performance and is not representative of any fund's performance. Indices are unmanaged and not available for direct investment. Assumes reinvestment of capital gains and dividends and no taxes.

Data Source: Thomson Reuters, 1/17.

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The blue region shows the return for an “opportunistic” investor who invested \$10,000 into the S&P 500 at the start of 1977 and added \$2,000 every time the market dropped 8% or more in a month over a 40-year period. Such a strategy took a total investment of \$38,000 to over \$1.1 million.

... opportunistic investors do better over time because they buy into panic rather than sell.

The orange region indicates the return from a strategy where an “apprehensive” investor sold \$2,000 each time the market dropped 8% or more in a month. This strategy returned just over \$278,000 over the period.

The difference in total return is so large because the opportunistic investor bought stocks from the apprehensive one who sold into panic, but achieving such stellar results required the buyer to meet three prerequisites.



1. **Be Mechanical:** The investor had to remove all emotion from the investment process and be willing to buy each time a yellow dot appeared.
2. **Go Against Instincts:** Survival instincts protect us from perceived danger, so buying into panic required a strong stomach until the experience gained taught the investor that the drawdowns were not a threat.
3. **Remain Disciplined:** There have only been a handful of yellow dots over the last 40 years, so the investor needed to exhibit tremendous patience and stick to the strategy.

These are no small hurdles. For example, the yellow dots centered around 2008 indicates that the investor would have had to invest five times within a span of a few months. Think back to state of mind during the financial crisis, and then imagine the fortitude required to buy when the “experts” were calling for the end of the world.

Simply put, opportunistic investors do better over time because they buy into panic rather than sell.

IMPLICATIONS FOR INVESTORS

Anyone with a brokerage account can become an opportunistic investor. All one needs to do is buy a fixed amount of an S&P 500 index fund each time the market falls more than 8% in a month. It's that simple.

NOTE: The S&P 500 consists of hundreds of large stocks that are diversified across many sectors. If a company goes bankrupt, there are 499 other stocks to dampen any impact. Single stocks only offer exposure to a single company, so the strategy depicted in the chart above is not suited for a single stock investment. Diversification is critical to its success.

The only work needed is to become comfortable with uncomfortable investments, and making this transition is not easy. However, it is not supposed to be easy. If it were, we all would be wealthy and never lose sleep over the fear of running out of money.

The good news is that behavioral changes do not require a PhD in Finance and/or access to superior information. All that is needed is a fundamental shift in how we think about volatility and what response is most appropriate.

The U.S. economy is \$20 trillion in size, and a loss of 8% or more in real value in a month is almost inconceivable. Hence, if the underlying value of our economy does not change much over time, a large drop in price cannot represent “damaged goods” but rather some other and likely temporary force.

Think about a department store that needs to liquidate winter clothing on its shelves to make room for spring arrivals. If they choose to run a sale on jackets, it's not because the quality of the jackets they were trying to sell has deteriorated. They just want to make room for swimsuits and polo shirts.

Stocks go on sale all the time for reasons unrelated to the quality of the assets they represent. The next time they do, think and act like an opportunistic investor by profiting from the fear and panic of others.

The bottom line is that those investors who can become comfortable with uncomfortable investments should do better over time.

Sincerely,



Mike Sorrentino, CFA
Chief Strategist,
Global Financial Private Capital
mikeonmarkets.com

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