Investor Insights and Outlook

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Why Do Investors Buy High & Sell Low?

Why do so many investors buy stocks when prices are up and sell when prices are down? Answers to these questions matter to all investors who have seen the stock market go up before the financial crisis, plunge in the depths of the financial crisis, and recover since then. Investors who persisted in their long-term investment plan into the whole market and weathered the short-term plunge are reaping their long-term rewards, leaving behind investors who sold their stocks during the plunge.

Stock prices are steered up and down by two drivers, a fundamentals driver and a sentiment driver. The fundamentals driver steers prices in directions pointed by fundamentals. The fundamentals of a coming financial crisis point down and the fundamentals driver steers prices down. The fundamentals of increasing corporate profitability point up and the fundamentals driver steers prices up.

The sentiment driver steers prices in directions pointed by cognitive errors and misleading emotions. The sentiment driver overpowers the fundamentals driver when sentiment is strongly positive, forming bubbles by steering prices up above prices justified by fundamentals. The sentiment driver overpowers the fundamentals driver when sentiment is strongly negative, forming negative bubbles by steering prices down below prices justified by fundamentals.

Cognitive errors are various ways our minds convince us of things that really aren't true. One of these errors is making flawed predictions about returns. Examples of this would be forecasting high future stock returns following high past stock returns and forecasting low future stock returns following low past stock returns. These errors magnify when the reasons for past high or low returns are vivid. Cognitive errors led many to forecast high stock returns in early 2000, following the high returns of 1999, when the technology revolution was vivid. Some forecasts also resulted in inaccurate expectations of low stock returns in early 2009, following the low returns of 2008, when the financial crisis was vivid.

Exuberance and fear are emotions that can magnify cognitive errors and strengthen the hands of the sentiment driver as it struggles with the fundamentals driver. Exuberance made it easy for the sentiment driver to overpower the fundamentals driver in early 2000, steering stock prices too high, creating a bubble. Fear made it easy for the senti-

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Advisor Corner

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Mutual Fund Categories: A Primer for Investors

Balanced Funds offer one-stop shopping by combining stocks and bonds in a single portfolio

With thousands of mutual funds[1] available today, selecting the most suitable ones for your portfolio can be tricky business. Overwhelmed by the sheer number of funds, new investors understandably may be confused.

Included below is a summary of a number of common mutual fund categories. Once you have some understanding of the different fund categories -- which determine the kinds of securities that fund managers select for their funds -- the industry's seemingly endless differentiation may start to become clearer. You -- and your financial professional -- can then devise a mutual fund investment strategy that will work for you, bearing in mind your time horizon, risk tolerance, and ability to withstand fluctuations in the value of your portfolio.

- **Global and international funds** can help diversify your assets into a wide array of foreign stocks and bonds. The difference between the two groups is that global funds may buy a mix of U.S. and foreign stocks, whereas international funds invest exclusively overseas. Under the two fund groups, there are regional funds and country funds designed to take advantage of specific investment opportunities in the world's developed and emerging countries. In terms of risk ratio, global and international funds vary widely from lower-risk funds that invest in established markets to higher-risk emerging market funds. Be aware that investors in international securities may face additional risks (such as higher taxation, less liquidity, political problems, and currency fluctuations) that do not affect domestic securities.
- **Aggressive growth funds** are, as their name suggests, among the most aggressive equity funds. Aimed at maximizing capital gains, these funds invest in companies with the potential for rapid growth (such as companies in developing industries, small but fast-moving companies, or companies that have fallen on hard times but appear due for a turnaround). Some aggressive growth funds use several investment strategies in an effort to achieve superior returns. These funds can be very volatile in the short term, but in the long run they may offer the potential for above-average capital appreciation.
- **Growth funds** also strive for capital appreciation by investing in companies that are positioned for strong earnings growth. Funds in this group vary widely in the amount of risk they take. But in general, they are less risky than aggressive growth funds because they normally invest in well-established companies. Growth funds may entail less volatility than aggressive growth funds, but also less potential for capital appreciation.
- **Growth and income funds** strive for both dividend income and capital appreciation by investing in companies with solid records of dividend payments and capital gains. Some growth and income funds emphasize growth while others emphasize income. Growth and income funds may be less risky and less volatile than pure growth funds, but may also offer less potential for capital appreciation.
- **Sector funds** concentrate on one industry (such as technology, financial services, or consumer goods) or focus on certain commodities (such as gold, gas, or oil). Selected by more experienced investors who are willing to pay close attention to the market, sector funds are less diversified than the broader market and hence are often more volatile.
- **Balanced funds** offer one-stop shopping by combining stocks and bonds in a single portfolio. Balanced funds are more conservative than the previously discussed categories and usually invest in blue-chip stocks and high-quality taxable bonds. They may potentially hold up better in rough markets, because when their stock investments fall, their bonds may do well, and vice versa. Because they offer diversification, balanced funds are often suitable for people with a small amount of cash to invest.
- **Bond funds** can be divided into four broad categories: tax exempt, taxable, high quality, and high yield. Within these categories, funds are also segmented by maturities, type of issuer, and credit quality of bonds in which they invest.
- **Tax-exempt bond funds** buy bonds issued by state and municipal agencies, while taxable bond funds may invest in all other debt securities.
- **High-quality bond funds** stick with government and top-rated corporate or municipal bonds that offer relatively lower interest.
- **High-yield bond funds**[2] buy lower-rated or non-investment-grade corporate or municipal bonds, or "junk bonds," which

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Is It Time to Rebalance Your Plan Investments?

Adjustments to your asset allocation should occur gradually over the years based on such factors as your projected retirement date and your comfort level with risk.

If you have not reviewed your plan holdings lately, you may be surprised at what you'll find. Even if you have not made a single change to your plan's investment mix, it's possible that your current asset allocation has drifted from what it was when you first started participating in your employer-sponsored plan.[1] That's why it is a good idea to review your portfolio at least once a year to determine whether it makes sense to rebalance -- or adjust -- your holdings and to ensure that your portfolio holdings fit your current investment needs and circumstances.[2]

Portfolio Drift

To appreciate how performance differences can affect an investment portfolio over time, consider what happened to a hypothetical portfolio of 70% stocks, 20% bonds, and 10% cash left unbalanced for the 20 years ended December 31, 2013.[3] The original 70% allocation to U.S. stocks would have grown to 84%, while allocations to bonds and cash would have shrunk to 12% and 4%, respectively, increasing the overall risk in the portfolio. Keep in mind that past performance is no guarantee of future results.[4]

Making Adjustments

Ideally, adjustments to your asset allocation should occur gradually over the years based on such factors as your projected retirement date, life events such as the birth of a child, and your comfort level with risk. As a general rule, the further away you are from retirement, the larger the role stocks may play in your portfolio.

For each review, calculate how much of your money is in stocks, bonds, and other asset classes. Then decide whether you are comfortable with those allocations. If not, rebalance to bring the allocations back to their intended targets.

Rebalancing your plan account holdings can be accomplished in one of two ways: changing your investment allocations on future contributions or changing your current mix of investments. Either way, you will want to reduce allocations to investments that exceed your target allocation and increase allocations to investments in the underweighted asset.

How often should you consider rebalancing? The usual answer is anytime your goals change; otherwise, at least once a year. However, during times of market volatility, it may be a good idea to keep close tabs on your holdings and make sure they do not drift far from your target allocation.

Source/Disclaimer:

[1]Asset allocation does not assure a profit or protect against a loss.

[2]Rebalancing strategies may involve tax consequences, especially for non-tax-deferred accounts.

[3]Investing in stocks involves risks, including loss of principal. Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rates rise and are subject to availability and change in price. Government bonds and Treasury bills are guaranteed by the U.S. government as to the timely payment of principal and interest, and, if held to maturity, offer a fixed rate of return and fixed principal value.

[4]Source: Wealth Management Systems Inc. Stocks are represented by the total returns of Standard & Poor's Composite Index of 500 stocks, an unmanaged index that is generally considered representative of the U.S. stock market. Bonds are represented by the total returns of the Barclays Aggregate Bond index. Money markets are represented by the total returns of the Barclays 3-Month Treasury Bills index. It is not possible to invest directly in an index. Past performance is not a guarantee of future results.

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Mutual Fund Categories: A Primer For Investors (continued)

offer higher interest to compensate for the higher risks that investors take. While bond funds in general are less risky than stock funds, the return on principal is not guaranteed and bond funds have the same interest rate, inflation, and credit risks that are associated with the underlying bonds owned by the fund.

- **Money market funds**[3] invest in short-term money market instruments, such as U.S. Treasury bills, commercial paper, certificates of deposit, and repurchase agreements. Striving to maintain a stable share price of $1, money market funds offer increased safety and liquidity, as well as a yield that is generally higher than that of bank deposits, which unlike money market funds, are FDIC insured.
- **Allocation/lifestyle** and **target-date funds** may be another option for investors looking to simplify their choices. Allocation or lifestyle funds invest in a static mix of stocks, bonds, and money markets based on a particular risk profile.[4] **Target-date funds** also invest in a mix of asset classes, but that mix changes over time as you approach the target date, typically your expected date of retirement. For example, a 2040 fund might feature a mix of stocks and bonds that gets progressively more conservative as you approach year 2040 and beyond. Note that the principal value of a target date fund cannot be guaranteed at any time, including the target date, and may decline at any time.

Which mutual fund categories will best meet your investment needs will depend on a number of factors, including your investment time horizon and your tolerance for risk.

Sources:

[1]Investing in mutual funds involves risk, including loss of principal. Mutual funds are offered and sold by prospectus only. You should carefully consider the investment objectives, risks, expenses and charges of the investment company before you invest. For more complete information about any mutual fund, including risks, charges, and expenses, please contact your financial professional to obtain a prospectus. The prospectus contains this and other information. Read it carefully before you invest.

[2]Lower-quality debt securities involve greater risk of default or price changes due to changes in the credit quality of the issuer. They may not be suitable for all investors.

[3]An investment in a money market fund is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency. Although the fund seeks to preserve the value of your investment at $1.00 per share, it is possible to lose money by investing in the fund.

[4]Asset allocation does not ensure a profit or protect against a loss in a declining market.

Why Do Investors Buy High & Sell Low? (continued)

ment driver to overpower the fundamentals drivers in early 2009, steering prices too low, creating a negative bubble. A question comes naturally to mind — why not bet against bubbles? The answer is in another cognitive error — hindsight error. Bubbles are seen clearly in hindsight, but they are not seen as clearly in foresight. Rather than trying to estimate what will happen with the market going forward, we should remember to maintain a long-term outlook for our investment strategies and chose a plan according to our investment profile.

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