“Only thing we have to fear is fear itself”
-Franklin Roosevelt – 1933 Inaugural Address-

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Dear Fellow Investors,

A great deal of financial theory is built on the belief that market participants act in a rational manner making decisions that maximize their wealth. As we’ve followed the markets for decades, we disagree with this assumption as human nature is a difficult force to overcome. We hope the following topics illustrate why we have our reservations. Please note, these concepts form the basis of a more recent school of thought called ***Behavioral Finance***. As we cannot possibly give these concepts justice in just a few pages, please give us a call if you would like to discuss them in greater detail.

This might not be surprising to hear, but people hate losing money. Study after study has proven humans exhibit ***risk seeking*** behavior in the hope to avoid a loss. As a matter of fact, not only do people hate losing money, but the memory of losses affects us far greater than the memory of gains. If you think about it, you probably know someone that absolutely will not invest money in the stock market because they recall, or heard from generations past, about how tough times were during the Great Depression. Or, you may know someone who pulled all their money out of the market during the Great Recession and instead shifted to “safe” investments like bonds and CDs. For some, not even years or decades of gains are enough to convince them their wealth would have been maximized by investing in the stock market.

We find this paralyzing “fear of loss” fascinating, as every long-term study (think of long-term as 30 years) shows ***stocks significantly outperform bonds***. Why then does traditional finance assume rational, wealth-maximizing investors need to be compensated for market risk when stocks have proven to be far less risky over the long-term? The answer may lie in human behavior. Perhaps stocks outperform bonds not because of some equity risk premium, but because investors need the potential of higher returns to overcome their inherent “fear of loss”.

We understand, the thought of losing money can be nerve-racking. However, we all need to keep something in mind. Stock prices fluctuating up and down (volatility) is not the same thing as risk. Instead, we define risk as not having the funds you need, when you need them, to pay for your goals. Putting risk in this goals-based framework can help temper the inevitable fears constantly thrust upon us: *Who will win the mid-term elections? What’s going to cause the next recession? Will interest rates rise too fast? Will the trade war with China intensify and lead to isolationism?* While all of these represent valid concerns, we need to keep sight of the far greater potential.

From 1929 to today (a period of 89 years), through World Wars, depressions, recessions, terrorist attacks, a Presidential assassination, political turmoil, rising interest rates, and falling interest rates, the S&P 500 (excluding dividends):

- Produced 60 years of positive returns and 29 years of negative returns – a 2 to 1 ratio
- An investment would have increased by 120 times in value
- $1,000 would be worth $120,000 today

In spite of this undeniable proof showing just how good stocks have been at creating wealth, studies show humans remain far more aware of negative circumstances compared to any potential good. This negativity and fear is most likely rooted in our need for survival. Thankfully, we no longer need to fear attacks from saber-toothed animals while out for a walk. ***Unfortunately, saber-toothed predators have been replaced by keenly aware media companies monetizing every search result, page view, & retweet created by sensationalized headlines:***

- These three conditions imply stocks will plunge more than 40% during next bear market – CNBC 10/3/2018
- Stocks will plunge 40% in next market crash: Harry Dent – Fox Business 2/9/2018
- Marc Faber predicting stock market plunge of 40% or more – Fox News 1/26/2017
- Market bubble ready to burst and stocks could plunge 20 – 40%, strategist warns – CNBC 4/5/2018
- World stock markets heading for 40% crash – Bloomberg Television 3/9/2018
- "Daredevil" stock market poised to drop 40% - Investopedia 6/8/2018

(Our guess is, putting the number 40% with plunge or crash in the headline must be working for generating page clicks and views.)

We emphasize that everyone has a certain amount of ***ability and willingness*** to take risk. Ability is determined by quantifiable items such as your income, savings accumulated, and time horizon. Willingness is determined by fuzzier factors such as personality, experiences, self-esteem, and feeling secure. When creating a plan to save for financial goals, the willingness of an investor to take risk should trump their ability. The problem we see today is investors with a high degree of ability find their willingness challenged by a constant bombardment of negativity. Please keep in mind, media companies are in the business of generating buzz and attracting readers and viewers. This will often be in direct conflict with the proper, wealth-maximizing behavior needed to reach your financial goals.

Blake recently wrote a white paper (An Old Paradigm with a New Reality) about how traditional asset allocation assumptions do not work in today's low interest rate environment. The paper lays out a plan to help investors mentally separate buckets of money in an attempt to maximize their wealth. This plan allows an investor's willingness to match their ability. As we can't deny human behavior, we might as well embrace it. We look forward to revisiting and possibly updating some of the concepts laid out in the white paper in our upcoming Annual Letter. With years of gains in the stock market and constant headlines about what will cause it to crash next, sorting through the noise and keeping a long-term perspective is harder than ever. We genuinely appreciate the trust and confidence you've placed in us in order to do so.

Sincerely,

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