ARK ROYAL
WEALTH MANAGEMENT

Helping Successful People Make Smart Decisions About Money

SUMMER 2017

ARE WE THERE YET?

I recently spent a week at Kiawah Island on a family vacation. Our entire family of six packed into our minivan (complete with rooftop luggage carrier) for a week of fond memories and fun-filled days.

As far as memories go, you just can't top the time-honored pastime of packing up the family car and embarking on a cross country trip to visit family, the beach or the mountains. The anticipation itself is hard to beat. And who can forget their myriad "firsts" that accompany many vacations—the sights, sounds, and flavors that leave an indelible memory.

On the other hand, family vacations aren't without their moments of torment. I'm sure we all experienced kids screaming in the backseat, creeping traffic around road construction or the occasional flat tire. Whether as the driver, the swiveling parent, the annoying kid, or the kid who is being annoyed, odds are that you've had a road-trip experience you would rather forget. But through the power of selective amnesia, the trip doesn't have to ruin the destination, or the sublime adventure in our mind's eye.

Investing isn't all that different from a family vacation. Like a road trip, one's investing journey may be sometimes thrilling, sometimes turbulent, and sometimes even boring. Whether we like it or not, these experiences are part of the highways and byways to our financial destination–even the car-sick memories of the 2008 investment markets that may overshadow the progress made on our journey. It may come as a surprise, but for the ten-year period ending June 30, 2017, the S&P 500 Index has posted investment returns of nearly seven percent (annualized) per year! (Source: *Morningstar*)

On your travels be sure to enjoy the scenic overlooks, the beautiful tidal marshes at sunset, and the thrill of boating on a lake under clear Carolina blue skies. But, also remember that we still have miles ahead of us. And when the ride inevitably becomes bumpy, or boring, or annoying, we must remember that it is very much a part of the path to financial progress.

The joy is in the journey, just remember the rules of the road: don't bother your sister…and, don't make me stop this car!

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IS THERE A BEAR MARKET ON THE HORIZON?

We are well into a prolonged bull market, now going on 99 months from the market low of March 2009. The S&P 500 is up 258% over that period, yet some investors have been waiting for the bear market's return. While it is certain that the current bull market will end at some point, it is far less obvious what the next bear market will look like. Each market cycle is distinctive, with some being very protracted (think the 1970's inflationary period) and some being relatively short-lived (think the crash of 1987).

Given that global markets are now more connected than ever before, it may be helpful to examine the two most recent bear markets to get a sense of what may be in store for investors whenever the current bull cycle ends. To that end, it is worth noting that the 2000–2002 and 2007–2009 bear markets (both of which coincided with recessions) were very different when broken down by sector. The 2000–2002 BEAR MARKET was very uneven, with consumer staples doing well, while other sectors (energy and healthcare) suffered modest losses. In contrast, the 2007–2009 BEAR MARKET was felt in every sector, with no sector suffering losses less than 30%.

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Interestingly, each of the last two bear cycles began with huge allocations within the S&P 500 to two sectors, financials in 2007 and information technology in 2000. Each cratered more than 80% before bottoming out. Four sectors (energy, healthcare, consumer staples, and utilities) managed to increase "market share," during the last two bear markets. It would seem markets, like nature, find a balance to excess. It is worth noting that as of July 31 the FANG stocks (Facebook, Amazon, Netflix and Google) currently make up 7% of the S&P 500. Add Apple and it goes to 10%.

For small stocks, the results during the two bear cycles were just as uneven as they were for large companies. Small value (Russell 2000 Value index) broke even during the 2000–2002 bear, while the broader Russell 2000 Index dropped more than 40%. However, during the 2007–2009 bear market, small value shares suffered just as much as other small company stocks, with both the Russell 2000 Index and Russell 2000 Value Index declining some 60%.

International stocks provided little cover during the 2000–2002 downturn, with the MSCI World ex-USA and the MSCI EM indices each declining about 45%. In the case of emerging markets, this decline was despite trading at roughly a 30% discount to the S&P 500's multiple at its 2000 peak, something that should give pause to investors who think that (current) relative value alone will provide shelter in the coming market storm.

During the 2007–2009 period, both the World ex-USA and EM indices declined about 60% as the bear market left no corners of the globe untouched. In retrospect, this should not be surprising given that correlation among global equity markets has been on the rise for years. It is worth mentioning that while current correlations are roughly twice what they were twenty years ago, they are currently far below the peak (SEPT 2009), which may indicate somewhat different results for U.S. and foreign equity markets whenever the bear market arrives.

What does this mean for investors? We believe attempting to time markets is a fool's errand. Instead, we believe it is critically important to maintain a stated equity target. Human nature being what it is, clients tend to overestimate their equity appetite in rising markets and underestimate it during declines. A key benefit we provide is to instill discipline during both good times and bad.

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We encourage our clients to ensure they have only as much equity exposure as their financial goals require, while maintaining sufficient sums of shorter-duration instruments such as cash and bonds (we recommend 18 months of living expenses for those near or in retirement).

Given extremely low current yields on cash and bonds (and the likelihood that with a significant movement of capital from equity to debt, yields would likely go even lower), it is doubtful bonds will perform as well as they have during past bear markets. However, we believe the value of fixed income is in the retention of value rather than an increase in it.

We caution against the siren song of non-traditional asset classes such as gold, inverse-ETFs and other "alternative" investments that profess to have non-correlation to equities. The evidence suggests these have little or no extended benefit and usually prove to be expensive traps for capital.

Other than adequate diversification, the simplest solution for weathering the coming storm is behavioral. We urge investors to save more, thereby reducing the impact of a bear market, whatever its ferocity, on their portfolios. This is easier said than done, especially in a rising market when net worth seems to grow monthly as if by magic. Yet in the long run it will prove to be the most effective insurance against portfolio losses of any depth or duration.

RISK AND RETURN ARE RELATED—BUT NOT ALWAYS

One of the key tenets of our investment philosophy is the belief that risk and return are related. For investors who desire returns over inflation, some risk is simply the cost of admission. This is known in academic circles as the "equity risk premium", and is an elemental principle of finance. However, it is worth noting that the reward for taking risk often goes unrewarded, especially when we look at investments in isolation.

Let's look at two of the better known technology stocks of this decade as an example, Facebook and Twitter. As one can see from the chart to the right, an investment in Facebook has done very well, provided one could weather an extremely volatile ride.

Twitter is a very similar company focused in the social media space, but with an almost diametrically different investment outcome as the second chart illustrates.

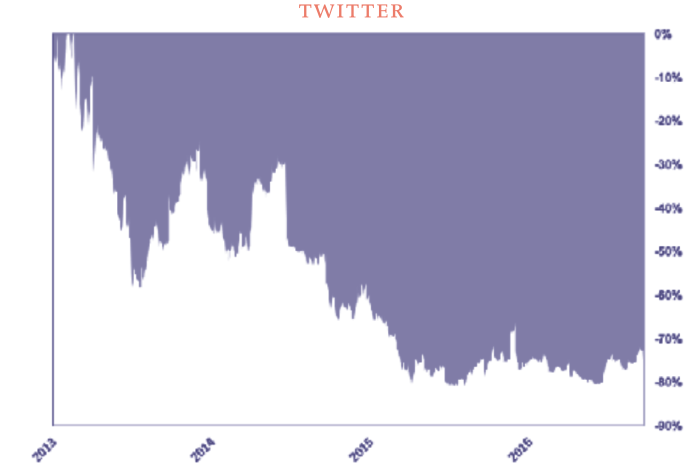
Investors love a great story. A compelling narrative has persuasive power over money. The media loves stories of the kind "If you had invested $10,000 in (insert asset that has huge gain) you would have made X." Everyone would like to be rich, and this plays on one of our baser behavioral biases (hindsight). Success stories make us all feel like it's possible to make huge profits by picking stocks that are sure things in hindsight. All we have to do is pick the next one and we'll all be rich.

"Unfortunately, for every Facebook there are a dozen or more Twitters."

Unfortunately, for every Facebook there are a dozen or more Twitters. And this is the very reason we opt for an investment strategy built on accepting asset class returns. By broadly diversifying across hundreds or thousands of companies, we allow the principle of risk and return to work effectively and efficiently on our behalf. It doesn't mean a guaranteed return, but over eighty years of academic research indicates it puts the odds of a successful investment experience in our favor.

FACEBOOK

TWITTER



IN THE NEWS

Mike Palmer was quoted in "How to Talk About a Will" in the **July issue of *Money* magazine.**

Ark Royal will be teaching several personal finance classes this fall. Our first workshop, "Ready, Set, Retire!" will be on Saturday, September 30 from 9–11am at our office in Raleigh. *If you'd like information on this or our other workshops please call Lisa Shirley at 919-710-8665.*

Our **2Q Market Review** can be found on our website in the Resources section.

> *"Far more money has been lost by investors preparing for corrections, or trying to anticipate corrections, than has been lost in corrections themselves."* PETER LYNCH

The CORNERSTONES *of*
ARK ROYAL WEALTH MANAGEMENT

To nurture a culture that puts our client's interest first—always

To be truthful at all times, to be intellectually honest with ourselves and with our clients, even if it isn't what they want to hear

A commitment to lifelong learning, and a passion for applying our wisdom efficiently and effectively every single day

Align what you say, what you do and what you think to honor yourself, your family and our firm