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The Fed blinks

The September meeting at the Federal Reserve was eagerly anticipated by analysts, economists, and short-term investors because there was the real possibility that central bankers would finally boost the fed funds rate for the first time in almost 10 years.

In case you missed it, the Fed chose not to raise rates in September, but left open the possibility we might see an October or December move.

While the meeting gave the financial press something to talk about (and talk about and talk about), let's take a longer-term perspective.

We can argue that the current economic environment is reasonably stable, and a fed funds rate that is stuck at zero is no longer needed.

At the press conference that followed the Fed's decision, Fed Chief Janet Yellen said the economy "has been performing well and impressing us by the pace at which it is creating jobs…" Still, that wasn't enough for the Fed to pull the trigger.

Instead, worries about what's happening in China and emerging markets were the primary reason the Fed chose to stay on hold. As Yellen noted at her quarterly press conference, "We focused particularly on China and emerging markets."

Post meeting, more than one Fed official acknowledged the decision was a close call (Reuters), and in a speech a week after the meeting, the head of the world's most powerful central bank said she expects that a hike this year in the fed funds rate is "likely" followed by "gradual" increases.

While I believe it is important to monitor various economic indicators and events that have the potential to impact various asset classes, it's also important to filter out "the noise" that only the shortest-term traders might find of value.

Perspective

In other words, let's put the last Fed meeting into perspective. Will it really matter one year, or five years, or 10 years from now that the Fed chose to raise or not raise interest rates at the September 2015 meeting? It won't.

It's the long-term that really matters, not the day-to-day or month-to-month gyrations in the market.

While rollercoaster rides can be fun for some (think the short-term or day trader) and unsettling for others, a more mundane approach is usually the best.

As the influential economist Paul Samuelson once said, "Investing should be more like watching paint dry or watching grass grow. If you want excitement, take $800 and go to Las Vegas." It's why I counsel that it is sometimes best to skip the financial news channels that focus on the ever-changing crisis of the month.

If we properly understand your tolerance for risk, then even those volatile days won't be very unsettling.

Market Performance			
	MTD* %	**YTD %**	**3-year** %**
Dow Jones Industrial Average	-1.47	-8.63	+6.62
NASDAQ Composite	-3.67	-2.45	+14.03
S&P 500 Index	-2.64	-6.74	+10.05
Russell 2000 Index	-5.07	-8.63	+9.54
MSCI World ex-USA* **	-5.29	-8.69	+1.90
MSCI Emerging Markets* **	-3.26	-17.18	-7.56

Source: Wall Street Journal, MSCI.com
*August 31, 2015 – September 30, 2015
**Annualized
***USD

A walk in the weeds

While my goal when I communicate with you is to convey complex topics in a relatable tone, once in a while, I find it necessary to get a bit wonky in order to drive home an important concept. But please stay with me. I recognize that some folks will glaze over when too many numbers pop up on a page, but the walk in the weeds will be brief…and I suspect enlightening.

Since 1928, the annual total return for the S&P 500 Index has averaged 11.5%, with the best return of 52.6% occurring in 1954 and the worst return of -43.8% occurring in 1931 (Stern School of Business at New York University).

Sixty-three years were positive and 24 were negative.

Since 1965, the annual total return for the S&P 500 Index has averaged 11.2%, with the best return of 37.2% occurring in 1995 and the worst return of -36.6% occurring in 2008. On a side note – while 2008 was a wretched year and nearly all asset classes took a temporary hit, stocks did bounce back nearly 26% the following year.

Continuing with our format, that is 39 years in the green and 11 years in the red. Simply put, the ratio improved over the last 50 years.

So far, this is pretty straight forward and supports the argument that stocks have a place in most portfolios, assuming at least a medium timeframe.

Now it's time for a slightly deeper dive before I pull it all back together.

Since 1928, the standard deviation of the annual 11.5% return has been 20%, which means that about 67% of all annual returns should fall between 11.5% plus or minus 20%. Or a range of -8.5% to 31.5%.

If we go out two standard deviations, about 90% of all annual returns should fall between -28.5% and 51.5%.

Interestingly, the standard deviation declined to 17% from 1965-2014, so two-thirds of all returns should fall between -5.8% and 28.2%. And 90% of all returns would land between -22.8% and 45.2%.

In reality, we experienced only two of the 50 years outside the range, with both years coming in below -22.8%.

One last observation–diminished volatility over last 50 years (given the lower standard deviation), did little to reduce returns.

What does all of this mean?

Time to get practical and extract ourselves from the numbers.

What I've provided is a high-level review of S&P 500 stock returns and volatility that surround the average annual returns. Some investors would easily look past such volatility while others would experience sleepless nights at the thought of their portfolio losing "two standard deviations" in one calendar year, even if the odds are low.

Only you know how you will react. That's why I counsel – Investor, know thyself!

It is also why I recommend what's called an "asset allocation approach," where we hold more than just one class of assets.

In addition to stocks, this would include various types of bonds that not only produce income, but have historically experienced much less volatility over the long term.

For example, the standard deviation for the average annual return of the 10-year Treasury has been 7.8% since 1928, which is less than half that of stocks. In other words, there are less ups and downs in Treasuries, which helps to reduce risk and volatility.

When we are young and may not need any cash for decades, it is usually wise to focus on capital appreciation, which entails more risk. But as we age, preservation of capital, quick access to our funds, and regular income become equally if not more important.

That's why the current correction has had less impact on those who have reduced exposure to stocks. But remember, these portfolios would be hard pressed to match stock market indexes when the bull market is raging.

Bottom line

Tommy Armour, who was one of the greatest golfers of the early 20th century, once said, "The way to win is by making fewer bad shots."

Diversification is a major step in the direction of taking fewer bad shots, and it is the key to long-term success.

Moreover, Benjamin Graham, known as the "Father of Value Investing" and a favorite of Warren Buffett, once quipped, "Individuals who cannot master their emotions are ill-suited to profit from the investment process."

Diversification and an investment roadmap that takes the emotions out of the investment equation have typically been the surest path to financial success.

In the late 1990s, many folks thought there were diversified simply because they owned 10 to 15 tech and dot-com stocks. In reality, they were chasing returns and saw their stocks bludgeoned post 2000.

These days, biotech has been the hot sector, though recent developments have forced a significant pullback in this sector.

While there may be reasons to overweigh or underweight various industry groups, I typically recommend investments that give you a stake in all the major sectors of the U.S. economy, as well as a modest share of the global economy.

But let's further reduce risk by inserting bonds, income-producing securities, and some cash into the mix.

While it's easy to adhere to the investment plan when times are good, some investors find it difficult when the road gets a bit rocky.

It's during times like these that detours tempt the investor. In most cases, however, you'll wind up in an unfamiliar neighborhood, and the delay will cost you precious time.

I hope that you have found this month's summary to be beneficial and educational. I always emphasize that as your financial advisor, it is my job to partner with you. If you ever have any questions about what I've conveyed in this month's message or want to discuss anything else, please feel free to reach out to me.

Georgia