New England Capital Financial Advisors
Independent Objective Advice

New England Capital Times

New England Capital Financial Advisors, LLC
Registered Investment Adviser

October 2017
Volume 43

Special Interest Articles:

Risk Lessons from the World of Behavioral Finance (Front page)

Geopolitical Risk (Front page)

"Change the changeable, accept the unchangeable, and remove yourself from the unacceptable."

-Denis Waitley: American motivational speaker, writer and consultant

Risk Lessons from the World of Behavioral Finance

By Christopher W. Beale, CFP®

I've noticed in several of my recent client meetings that the topic of risk is being discussed more often. I think this is a good thing. Unlike Chris Lee's article in this newsletter which discusses large, geopolitical economic risks from around the world, I want to concentrate on risks closer to home, specifically individual self-inflicted risks.

Behavioral finance which is a relatively new field of study can help us make better decisions which allow us to reach our financial and life goals. Behavioral finance attempts to understand the biases of human behavior when it comes to money. Imagine economist Adam Smith got together with psychoanalyst Sigmund Freud and combined their two fields of study!

A quick review shows the economy continuing its slow but steady ascent. The economic output grew at a 3.1% annual rate in the second quarter, slightly stronger than previously thought and marking the best growth in two years according to the US commerce department. Unemployment remains low and the stock market as measured by the S&P 500 is up 12.5% year to date according to the Wall Street Journal. Also worth noting is that markets have generally been calm this year. The VIX, or volatility index listed on the Chicago Board of Options Exchange (CBOE) has mostly stayed in a very narrow range indicating little expectation of future volatility.

The above information can lead to what behavioral scientists call **anchoring** and **availability bias**.

Availability bias causes investors to be strongly influenced by what is personally most relevant, recent or traumatic. Anchoring causes us to focus too heavily on one piece of information when making decisions. So if the one piece of information we're focused on is the fact that the market has gone up 12.5% this year, our bias will be that this trend will continue into the future.

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Geopolitical Risk

By Christopher M. Lee, CFP®

With President Donald Trump making headlines on an hourly basis and our social media accounts going crazy with comments on his presidency, we are left asking ourselves: Should we perhaps change our investment strategy as a result?

First we need to identify what this alleged "new risk" - *Geopolitical Risk* - is. Geopolitics is defined as the study of how geography and economics influence politics and the relations between countries. An example of geopolitical risk would include a flare-up of tensions between Saudi Arabia and Iran that resulted in a spike in the price of oil.

Another example includes a banking crisis in Europe that results in foreigners buying U.S. Treasuries in vast quantities, which could result in American bond yields falling (supply versus demand – the greater the demand – the lower the yield gets pushed).

However, history tells us that financial markets are capable of absorbing a great deal of negative news and pricing in that information accordingly (arguably, the biggest issue markets confront is uncertainty). Below are some real geopolitical events and their past effect on the markets:

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Risk Lessons from the World of Behavioral Finance

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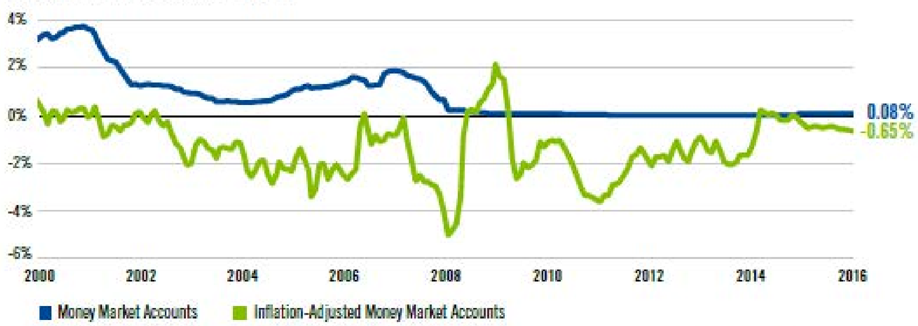
Mutual fund company, Franklin Templeton, conducted a survey of investors about expected return over a five-year period. The median response was that survey participants expected an annual return of 8%. After being presented with a hypothetical market return of 20% per year and asked the same question about the next five years, survey participants increase their expectation to 15%. The same biases work in reverse too. In 2008 during the Great Recession, the stock market was down 37% as measured by the S&P 500. In 2009 the S&P 500 rebounded with a return of 26.5%. In 2010 the investors survey conducted by Franklin Templeton, fully 2/3 of participants thought the market for 2009 was down or flat. Obviously we are strongly influenced by most recent events and we tend to anchor our perceptions to market highs and lows. This sets us up for unrealistic future return expectations which cause us to make investment decisions based on perception, not facts.

In his recent book *Misbehaving*, University of Chicago Booth School of Business professor and 2017 Nobel Prize winner, Richard Thaler, thinks **loss aversion** is the most damaging behavioral bias. Losses have about twice the emotional impact of an equivalent gain. Fear of loss can inhibit appropriate risk taking, such as investing part of your long-term assets in stocks. The stock market has a history of providing much higher returns then investing in bonds and money markets. However, stock prices fluctuate more, producing greater risk of losses. Loss aversion can prevent investors from taking advantage of the long-term opportunities in stocks. When the stock market takes its normal and inevitable step back, investors often react by flocking to cash or money markets. As the chart below shows the average money market account yield with and without inflation adjustments since 2000 has been extremely low. While I feel money market accounts are appropriate for a portion of anyone's portfolio and provide a more secure and liquid investment option, they also will expose us to purchasing power risk. Purchasing power risk is caused when prices of goods and services increases over time.

MONEY MARKET ACCOUNTS' AVERAGE YIELD BEFORE AND AFTER INFLATION[7]

January 1, 2000–December 31, 2016



This chart is for illustrative purposes only and does not reflect the performance of any Franklin Templeton fund. It's important to note that money market accounts are insured by the Federal Deposit Insurance Corporation (FDIC) for up to $250,000.

6. Source: Federal Reserve Bank of St. Louis.
7. Sources: Money Market Accounts' Average Yield: BanxQuote® and Federal Reserve Bank of St. Louis; Inflation: Bureau of Labor Statistics. Inflation is represented by year-over-year changes of the Consumer Price Index (CPI) plotted on a monthly basis.

Another damaging investor bias is **overconfidence**. Most people think they are above average, whether this pertains to investing or other areas of our life, including our driving ability and our children's accomplishments. Overconfidence in investing will result in people trading too much and diversifying too little. This can also lead to investing during what appears to be a bubble, thinking they can get out faster than others. As a side note, men suffer from overconfidence in investing more than women. Of course women know this already!

Herd behavior or following the crowd is quite common. Investors face strong temptations to join the bandwagon based on emotion rather than a sound financial strategy. Following the crowd by buying a hot stock or buying real estate at inappropriately high levels, and conversely panicking by selling into a market drop, can lead to devastating long-term financial results.

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"Start by doing what is necessary; then do what is possible; and suddenly you are doing the impossible."

-St. Francis of Assisi:
Catholic Saint and founder of Franciscan Order

Risk Lessons from the World of Behavioral Finance

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Mental accounting is the tendency of people to designate money for certain purposes. For some, money in a low interest savings account or even stashed in a jar is only for savings. This means they cannot use it for the more financially sound purpose of paying down debt at 15 or 20% interest.

The goal of behavioral finance is to make better investment decisions which allow us to reach our financial and life goals. Most of us know that at some level we suffer from self-control problems but we underestimate the extent of their consequences. Whether it's thinking we can stop for just one beer on the way home, a small piece of cake won't matter to our diet, or we can save more by cutting back on unnecessary expenses only to find that our credit card balances are still increasing, the best way to deal with the biases we understand from behavioral finance studies is to be self-aware and preemptive. Avoid buffets when possible, don't stop for the first drink, put the alarm clock on the other side of the room so you can't hit the snooze button, and sign up for your 401(k) and increase it automatically on an annual basis.

To be successful we don't have to be correct on every decision we make overtime, we just need to avoid most of the normal mistakes that the average investor makes.

"Don't judge Each day by the harvest that you reap but by the seeds that you plant."

-Robert Louis Stevenson: Scottish Novelist, poet, Essayist and Travel writer

Geopolitical Risk

(Continued from page 1)

		Closing level			Bottom			
Events	Date	Prior Day	Next Day	% Change	Level	Days	% Change	Days to Recover
Geopolitical Events								
Downing of MH17	7/17/2014	1981.6	1978.2	-0.2%	1958.1	1	-1.2%	5
Donbas conflict erupts	4/13/2014	1815.7	1830.6	0.8%	0.0	-		-
Crimea conflict	2/27/2014	1854.3	1859.5	0.3%	1845.7	4	-0.5%	5
Japanese Tsunami	3/11/2011	1295.1	1304.3	0.7%	1256.9	5	-3.0%	13
Madrid Bombing	3/10/2004	1140.6	1106.8	-3.0%	1091.3	15	-4.3%	23
September 11 Attacks	9/11/2001	1092.5	1092.5	0.0%	965.8	11	-11.6%	30
Iraq's invasion of Kuwait	8/2/1990	355.5	344.9	-3.0%	307.1	22	-13.6%	188
Ronald Reagan Shooting	3/30/1981	134.7	136.0	1.0%	132.7	1	-1.5%	1
Nixon Resignation	8/8/1974	82.7	80.9	-2.2%	62.3	57	-24.6%	209
OPEC oil embargo	10/17/1973	110.2	110.0	-0.2%	110.0	1	-0.2%	2
Kennedy assassination	11/22/1963	71.6	69.6	-2.8%	69.6	1	-2.8%	1
Cuban missile crisis	10/22/1962	55.6	53.5	-3.8%	53.5	2	-3.8%	3
Pearl Harbor Attack	12/7/1941	9.3	9.0	-3.8%	8.4	23	-10.2%	36
Other major market events								
Lehman Bankruptcy	9/15/2008	1251.7	1213.6	-3.0%	676.5	176	-46.0%	827
Collapse of LTCM	9/23/1998	1029.6	1042.7	1.3%	959.4	959	-6.8%	28
Black Monday - 87 crash	10/19/1987	282.7	236.8	-16.2%	224.8	1	-20.5%	367
Median Geopolitical Events				-0.2%		4	-3.4%	5
Median Other Major Market Events Events				-3.0%		176	-20.5%	367

Source: Nystedt, Jens; "Is it time for Markets to Worry about Political Risk?" Council on Foreign Relations, Morgan Stanley Investment Management, 4/26/2017

As you can see in the examples above, there is a not a huge variation in returns immediately following a negative event (as shown in the 5th column represented by the next day's % change in the markets). From there, the majority of "Days to Recover" from a market bottom (following that specific geopolitical event) are between 1 day to 36 days (with a couple of outliers at 188 days and 209 days, but still less than 1 year).

History does tend to repeat itself (although I can guarantee the geopolitical event will be somewhat different this time), so given the data above we can show that although it does have some impact on the markets, but it does not have a big impact. We may feel like it has a huge impact on the stock markets, because of one of the most powerful and paralyzing emotions we here at New England Capital see on a weekly basis with clients – fear. Fear of the unknown, fear of getting into a war, fear of one more Tweet!

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Geopolitical Risk

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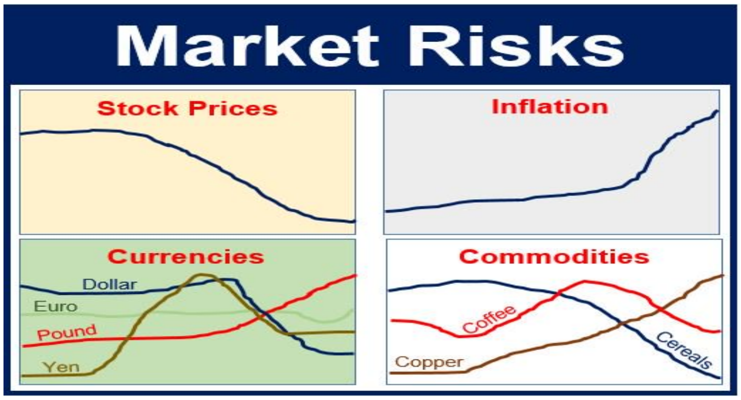
"All generalizations are false...including this one."

-Mark Twain: American writer, humorist, entrepreneur, publisher and lecturer

In my opinion, what we should be concerned about more than geopolitical risk is market risk. Market risk is defined as the possibility for an investor to experience losses due to factors that affect the overall performance of the financial markets in which he/she is involved. The four factors in market risk are:



These are the risks that our Investment Committee reviews, analyzes, assesses, and makes adjustments so that we can try to mitigate those risks in the best way that we can, while trying to obtain the greatest rates of return for the least amount of comparative risk.

My final advice is this – don't get caught up in the emotional aspect of Geopolitical risk. As you invest over the long term, short term market movements (and losses) are temporary. We have put together diversified portfolios for you with some of the best portfolio managers in the world. No one knows where the next 6 months will take us, but what I do know is that a well-diversified portfolio (based on your risk tolerance) **will be your key to long term financial independence!**

New England Capital News

- Thank you to everybody who attended the shredding event at our office on Saturday October 7th. It was a huge success! Safeguarding your personal information is one of our top priorities. Be sure to keep an eye out for future events as we will be having more targeted events in the coming months.

- Congratulations to Chris Beale, Chris Lee, Ann Ocone, Gary Maratea, Matt Sczurek and Deb McConnell for completing the Fishbein/Wallingford YMCA 5k on Sunday October 8th! The proceeds from the annual Fishbein/YMCA Road Race benefited the LIVESTRONG at the YMCA program.