

Investment Headlines can be Misleading

I know it is bad when my husband comes home and asks if we should take our money out of stocks because “the market is at all-time highs”.

Sigh... Sometimes a little information is dangerous.

Unfortunately, I know where his concern comes from – and I know he is not alone in his feelings. I’ve had several clients express a similar sentiment to me this year, especially those that make the mistake of tuning in to some of the financial news networks that have to try and fill a 24 hour news cycle.

In this era of almost instant access to information and so many sources competing for our attention, media outlets are pushed to sensationalize headlines to try and catch our interest. A boring headline like, “Market Posts Gains in 2014” is nowhere near as exciting as, “Market Skyrockets to All Time High”. The second is more likely to garner attention so is often the one that is used but both can be considered misleading as they contain information that could be construed incorrectly. It all depends on the definition the reader infers from the words they use.

Let’s start with using the word “market”. What exactly is the article referring to as the market? The investment world is actually made up of tons of markets – there are multiple stock markets in the US alone plus many more around the world. Additionally, there are bond markets, commodities markets, currency markets, etc.

The word market is too vague to actually mean anything without some additional context but many people reading it might assume it is a generalization for all investments, which would make the statements flat out wrong.

In 2014 there was a large divergence in performance across various investment categories. For example, the best performing broad asset class was US Investment Real Estate (MSCI US REIT) which gained just over 30% for the year and the worst performing broad asset was commodities (Bloomberg-UBS Commodity) which lost 17% and was led down by Crude Oil (WTI Spot Price) which fell nearly 46%.

Even if we make the assumption that “market” was meant to imply only more traditional stock and bond investments there was still a large divergence in returns during the year. Large Cap US stocks (S&P 500 Index) gained 13.7% during the year while Small Cap US Stocks (Russell 2000) gained only 4.9% and Foreign Developed Market Stocks (MSCI EAFE) declined 4.5%.

Bond market returns saw similar variability – the broad US bond index (Barclays US Aggregate Bond) showed a nominal return of 5.9% but that was largely driven by outside returns in long term treasuries fueled by the unexpected drop in interest rates. Returns in other bond sectors were significantly less, and in some cases negative.

Beyond all of this though, should we be concerned if stock prices are setting new highs?

In a word, no.

You see, index values like the ones that I referenced are not generally adjusted for inflation. The fact that the Dow (Dow Jones Industrial Average) is near 18,000 is not a concern in and of itself because we would expect that it would rise over time just as the price of goods and services does.

We all either remember or have heard stories of walking down to the corner market and buying a candy bar for a nickel. That same candy bar today would likely cost over a dollar. Is it because candy has become more scarce or suddenly that much more valuable to us? No, the price increase is a reflection of inflation.

That same concept can be applied to stock prices. At the core stock prices are a function of what investors are willing to pay for every dollar a company earns annually. If over time a company's earnings increase from \$5 million a year to \$100 million a year (the same percentage increase as the candy bar reference) then everything else being equal the price of the stock should be 20 times higher as well. Just as inflation can go on forever, so too can the price of stocks.

The bottom line is that we all need to take the headlines with a grain of salt and remember that there is no such thing as a magic investment that will do well in every market environment. Over nearly 20 years of doing this I've learned that the keys to long term investment success are diversification and patience. Unfortunately, that's not a headline that is likely to grab much attention.

All indices are unmanaged and investors cannot invest directly into an index. Forward-looking statements are not guarantees of future performance and involve certain risks and uncertainties which are difficult to predict. Past performance is not indicative of future results. Diversification does not ensure against market risk.

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