



Measure Risk, Invest Accordingly

October 20, 2023

Executive Summary

Over the last two generations, the financial landscape in the United States has shifted. Increasingly, Americans are having to rely more and more on how much they set-aside during their careers and how well those dollars were invested.

While Americans are, by and large, an educated population, most Americans have little to no training in investment portfolio management. Consequently, an entire industry has been born to fill that gap. Too often, however, the financial community offers advice that ignores history. The average American does not have a “long term” time horizon and, as this paper will show, even when they do, history is ripe with examples where the “long term” offered flat to negative stock market returns.

The standard financial advice is to “ride out” short-term volatility. This paper argues that to invest well over a long-term, sometimes we have to first survive the short-term.

In this paper, we will highlight some of the fallacies of the financial services sector and how those fallacies can have an incredibly detrimental effect on your long term financial stability. We will also show how we measure risk first. Only after measuring the risk of the environment do we proceed to invest for clients.

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It's All On You Now

Historically, Americans had three sources of financial security in their golden years. Many could count on receiving a company pension. Since 1935, Americans could also count on the Social Security Retirement Benefit. In addition, some saved and invested themselves during their career. This landscape has changed.

Today, most employers have abandoned their pension plans and Social Security is dangerously underfunded. As a result, the wise American knows that their financial security in retirement relies solely on their own savings and investing habits.

Unfortunately, they likely have bad habits.

There are ample papers written expounding on the average American's low rate of savings. There is not, however, enough written about the poor investing habits of the average American. These bad habits are, in part, due to the poor counsel Americans receive from academia and the typical Wall Street firm.

Investing Is Not Taught

The United States is a very educated country. However, most states do not require any financial courses as a high school graduation requirement.¹ Worse still, even when finance is taught, the topic is broadly covered. From a certain point of view, this is good news for the financial services industry. If the American people are confused or uneducated on financial matters, rest assured the financial services industry is there to help.

While certainly good intentioned, too often the financial sector offers platitudes based on poorly conceived academic theories.

This paper will look briefly at two examples. We will discuss the cliché of investing for the long term. We will also look at financial academia's shining star, the "Modern Portfolio Theory".

1. *The Nation's Report Card on Financial Literacy* - published by the American Public Education Published July 13, 2021 Revised January 19, 2022

Investing for the “Long Term”

According to a December 2022 FINRA Research Paper², an overwhelming 96% of survey respondents indicated that they invest “to make money in the long term”. While this seems like an obvious statement, it merely indicates that the investing public is regurgitating the maxims espoused by financial institutions and academia alike.

What’s wrong with their answer?

There is nothing wrong with their answer. The problem is the question.

Whenever the stock market goes through a period of volatility, the financial pundits implore the rank and file to remain focused on the long-term. In other words, John Q. Public is regularly encouraged to ignore short-term volatility and “hold” for the long-term. The implication is that the stock market always comes back up, therefore, just ride out negative volatility by staying focused on the long-term.

Unfortunately, those who preach this “buy and hold” doctrine have not examined the evidence. The reality is that there have been multiple periods throughout the history of the United States where such inaction would have been incredibly detrimental to one’s long-term financial security.

Yes, you should invest for long-term gain. Sometimes that means surviving in the short-term.

Long Term Challenges

Over the last 100 years, the United States stock market has returned, on average, ~7.4% per year (adjusted for inflation). While it is often attributed to Yogi Berra we are not convinced he actually said this, nonetheless, he allegedly once quipped:

Averages don’t mean nothing. If they did, I could have my hair on fire and my feet in a bucket of ice and, on average, I’d be comfortable.

It is not just a cute cliché; it is true. The cited statistic is accurate, but it is 100% irrelevant because you do not have a 100-year time horizon.

Most Americans have approximately 20 years to invest for retirement.

². *Investors in the United States: The Changing Landscape* - A Report of the FINRA Foundation National Financial Capability Study December 2022

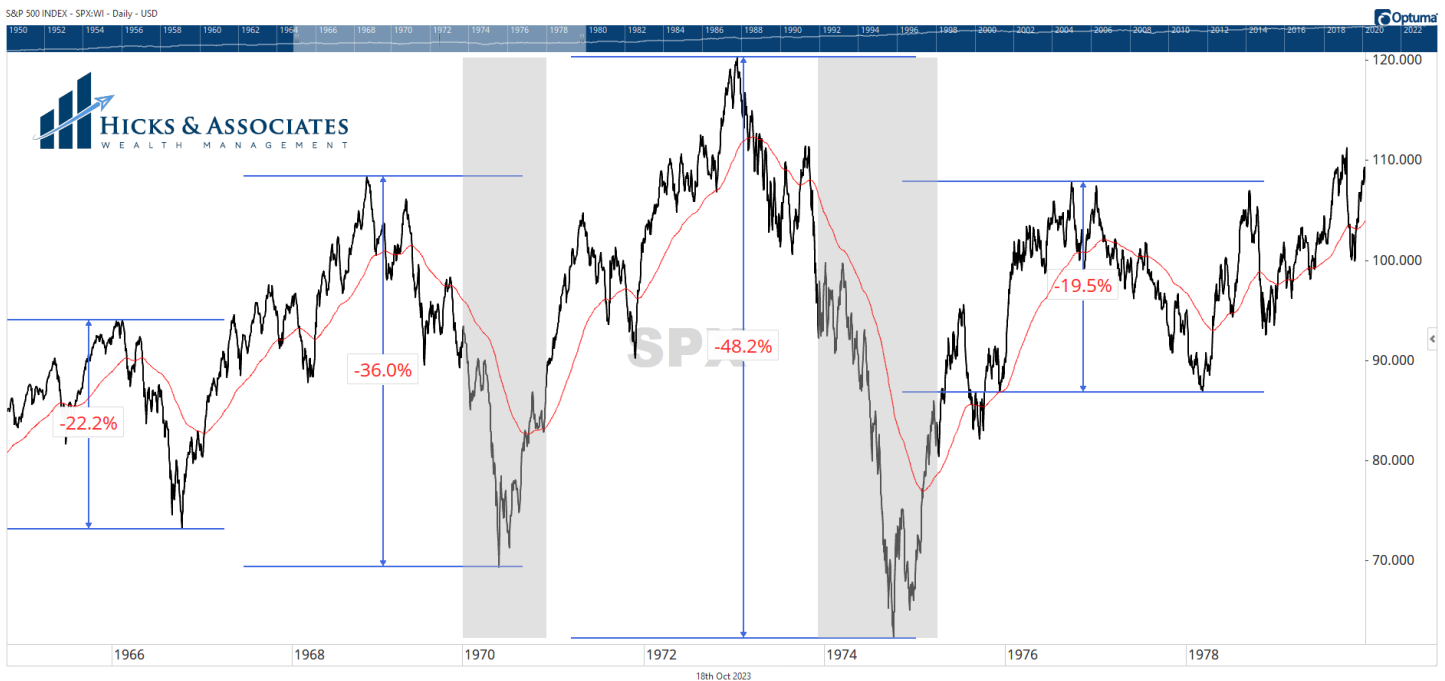
Retirement is another ~20-year time horizon.³ As a result, when you “invest for the long term” you are really talking about investing for a much shorter time period. That is where the problem lies.

In our nation’s history there are numerous examples of prolonged challenging stock market environments. While these periods are captured in the 100-year historical average statistic, the 100-year time frame effectively hides these challenging climates as they are offset by robust thriving market environments.

But which of these two very different climates will you experience over the next twenty years?

Secular Bear Markets

The chart below shows the S&P 500 from 1965 through 1979. This is a fifteen-year time frame, one that most academics would consider to be a “long term” time period.



In examining this chart, imagine yourself to be 45 years old. If you are like most 45-year-olds, you are beginning to make a transition from raising a family to thinking about retirement. While your golden years are still a few years away, they are starting to come into view. The good news is that

³ Certainly some Americans start saving and investing immediately upon entering the workforce and, as a result, have a longer time horizon to invest. But we are talking about the typical American who delays many years before they start investing for the future. Likewise, some Americans enjoy retirement for 30 or even 40 years. Again, we are suggesting that the average American has a retirement of approximately 20 years.

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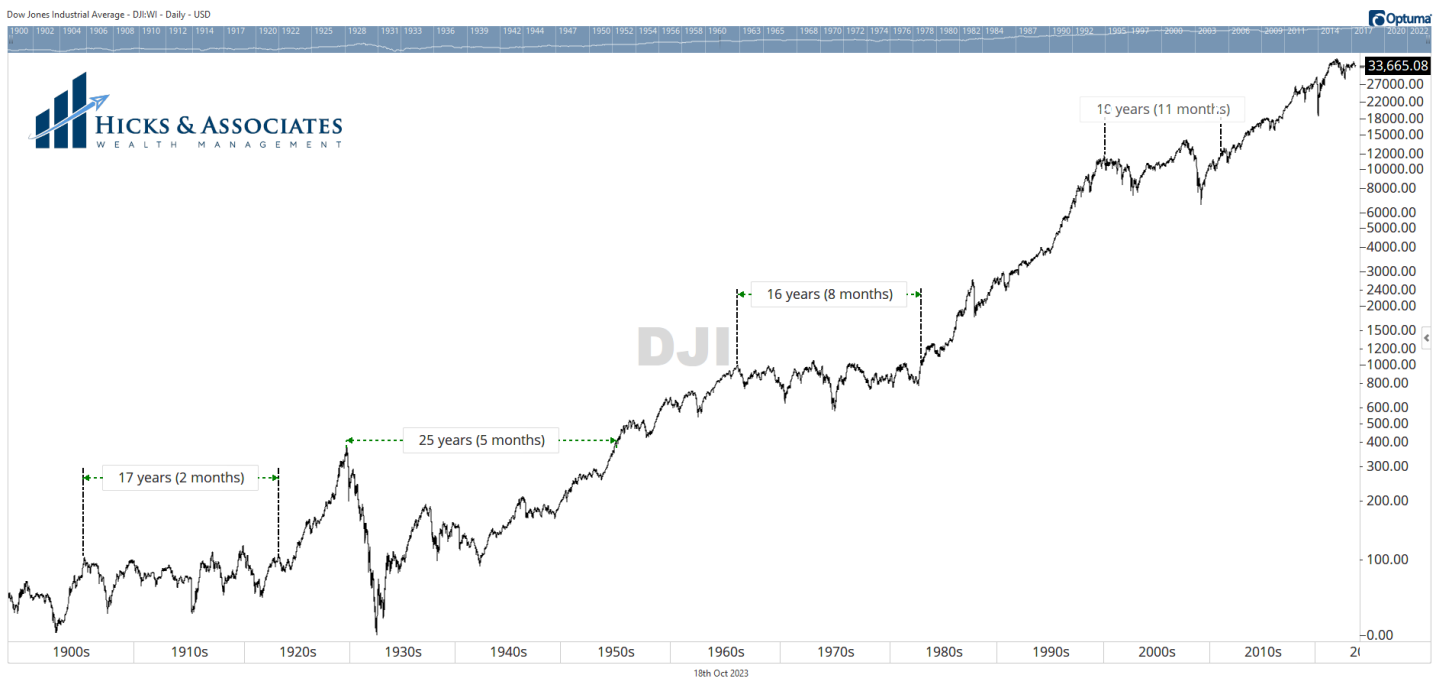


you are in your prime earning years and, as a result, you have a greater ability to set aside a larger percentage of your earnings. So, you invest for the “long term”.

Unfortunately, this 15-year “long-term” period included 4 cyclical bear markets within a broader secular bear market. If you had invested in the S&P 500 with a traditional “buy and hold” approach, riding out the volatility like the academics and financial media tell you to, you would have received an approximate return of 2% per year on “average” (not counting dividends).

And you would have gotten that 2% return in a **very** violent fashion.

Least you think this is a cherry-picked sample, there are numerous examples in the United States stock market’s history that have resulted in flat to negative returns. Below is a chart of the Dow Jones Industrial Average⁴ dating back to 1900. Note the time measurements. We would consider each of these time periods to be a “long term”.



The conclusion: A buy and hold approach, where you ride out the volatility, will not always work in the time horizon **you** have available.

Now, let’s add inflation into the mix.

⁴ The Dow Jones Industrial Average is an unmanaged index of 30 of the nation’s largest industrial stocks as determined by the Dow Jones company. The Dow Jones Industrial Average is one of the first equity indexes created by Charles Dow as a way to gauge the overall trend of the United States Stock Market.

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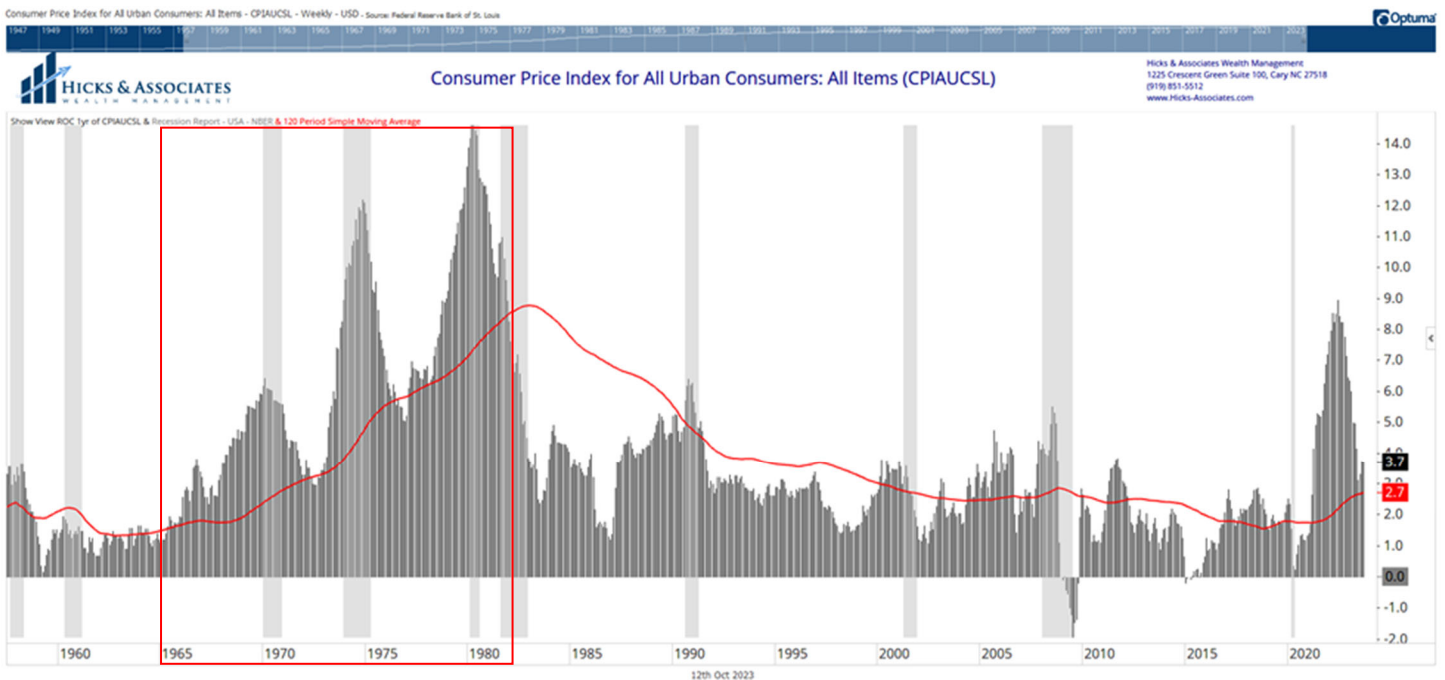
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Inflation Makes It Worse

It has been said that inflation is the silent thief as it steals your purchasing power without you realizing it.

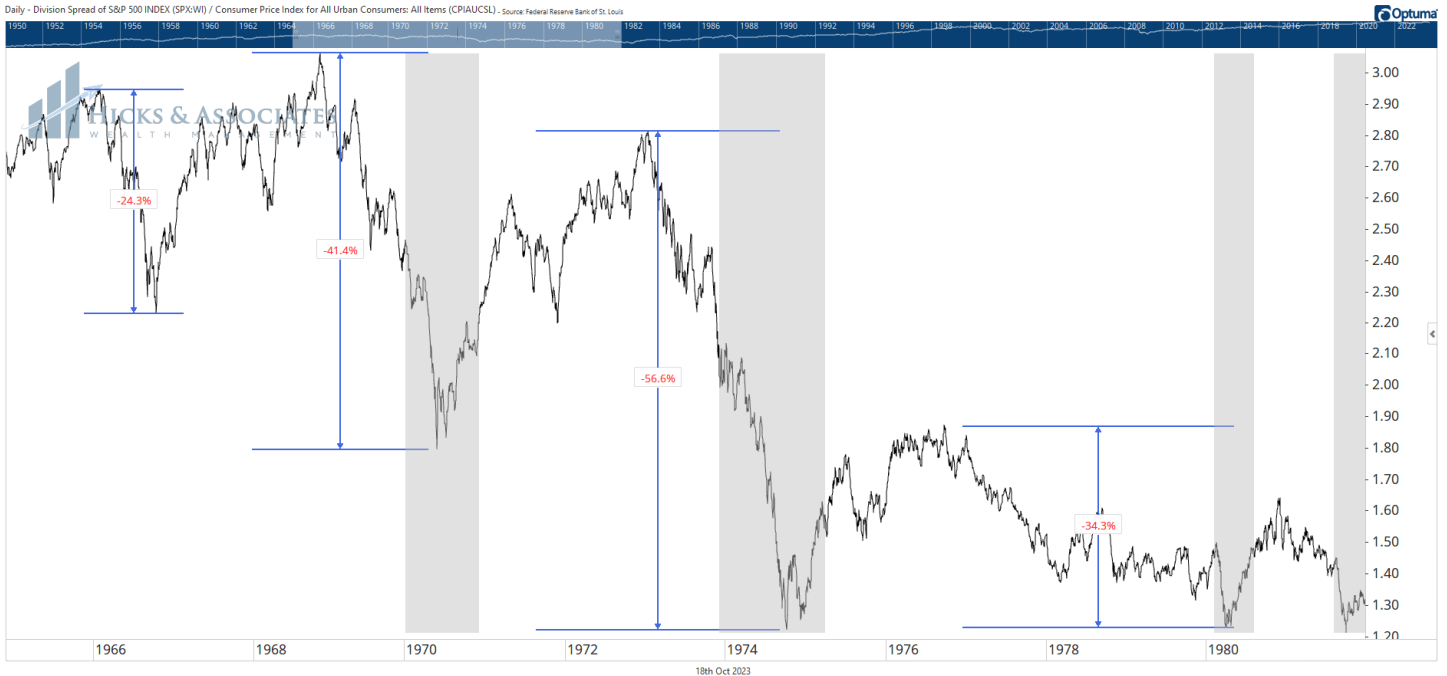
If you know your history, or if you lived through it, you know that inflation was a major problem in the United States from the late 1960s through the '70s. The chart below shows the Consumer Price Index from the late 1950s through the present day. The red box highlights 1965 – 1979 as we will return to that period. The red line represents the 10-year average.



With a reminder of how bad inflation was during this time period, let's return to the chart of the S&P 500. However, let's add two more years, 1980 and 1981.

The chart at the top of the next page shows the S&P 500 from 1965 through 1981 but, this time, it is adjusted for inflation.

Inflation Makes It Worse



This is a devastating chart. And **it is not hypothetical**. It happened.

What if those were your peak earning years? What if those were the first 17 years of your retirement?

Taking Risk When Appropriate

We have shown that without foresight the future path of the stock market is unknown, even for the “long term”. As a result, we need to consider a different approach.

If we were to examine your driving history, we would likely see that you drive differently based upon the conditions. For example, when it is raining, you likely drive a little more cautiously. If the down-pour is heavy, you might even drive well below the posted speed limit. If there is a Hurricane coming, or a blizzard, you likely do not drive at all. You drive based upon the driving conditions.

Why should investing be any different?

In certain market environments, as we will show, investors are not rewarded for taking risks. In those conditions, should we not alter our investing behavior?

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Modern Portfolio Theory

What has become known as Modern Portfolio Theory is widely considered sacrosanct by academia and most of the financial industry. The reality is that a careful study of the theory reveals that it is not Holy, but full of holes.

Space does not permit a full refutation of the Efficient Market Hypothesis and Modern Portfolio Theory. (Perhaps that will be the next paper we publish?) We will, however, briefly highlight some of the biggest flaws in the theory.

In the 1950s, a graduate student named Harry Markowitz wrote a paper for his PhD dissertation. The paper was very well received and young Mr. Markowitz rightly became Harry Markowitz, PhD. The paper was indeed ground-breaking. Markowitz's paper examined a revolutionary new way to minimize risk in a portfolio of securities. However, it should be noted that the paper was written for the purpose of obtaining a doctorate. Markowitz had no idea that his paper would reshape financial academia for decades to come.

At the time of publication we can assume the paper, and later the full monograph⁵, was widely read. However, we would contend that today the vast majority of retail money managers have never read his paper and certainly not his longer monograph. Likewise, we would contend that most of financial academia, while aware of Markowitz's work, most likely read the Cliff Notes not the paper nor the monograph.

If you were to read either, you will find that his theorem hinges on **expected** returns. Markowitz's theory **assumes that historical security returns are indicative of future returns**. It seems that the financial industry had not yet popularized the ubiquitous disclosure, "*Past performance is no guarantee of future results*".

Worse still is that his math factors in "carefully considered expected returns". (Pages 96-97) He suggests that, in order to concoct a proper mixture of securities to include in your portfolio, you should consult Wall Street security analysts who will have "carefully considered" return expectations for various securities.

⁵ *Portfolio Selection: Efficient Diversification of Investments* Second Edition by Harry M. Markowitz; first edition published in 1959 by Cowles Foundation for Research in Economics at Yale University, second edition published by Basil Blackwell in 1991. Pages cited are from the second edition.

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Diversification Will Not Save You

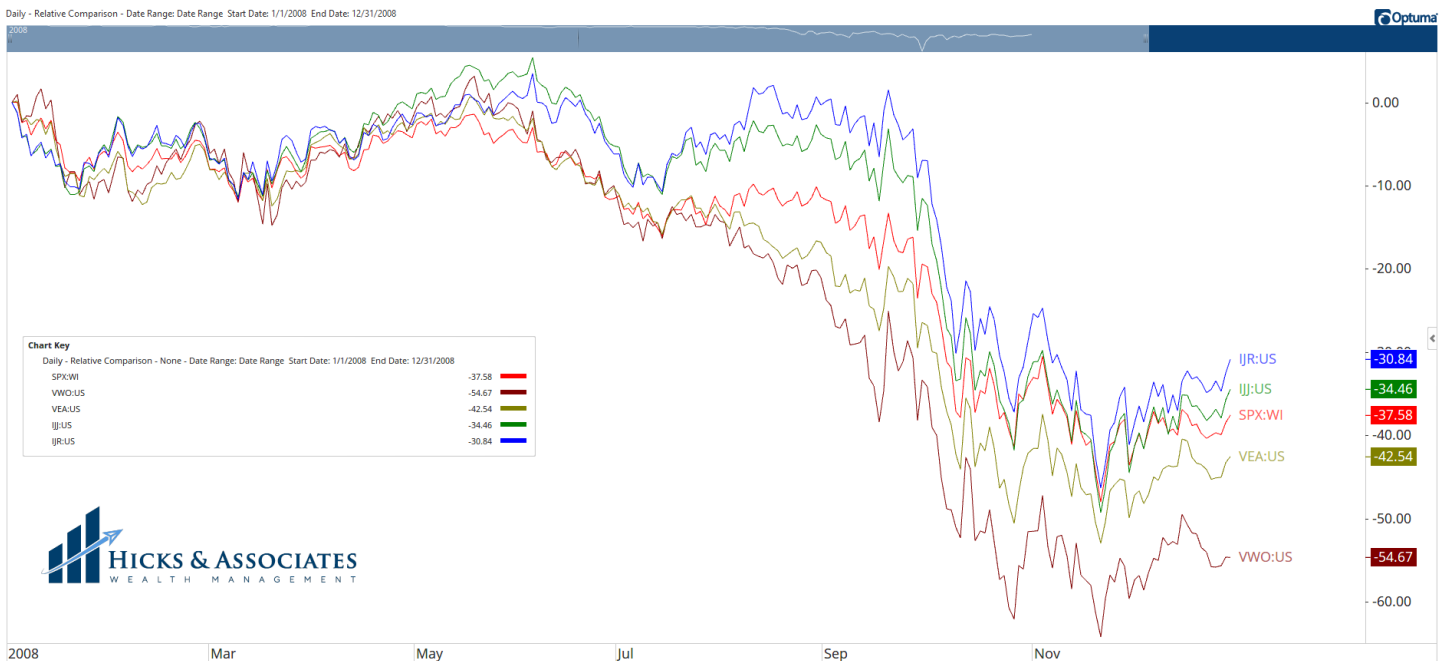
If the aforementioned security analysts were any good, you might suggest, why not just pick the security that they expect to outperform all the others? Well, naturally, these “carefully considered expected returns” might be wrong.

This is where Markowitz introduces the idea of diversification. After some additional mathematical computations, he concludes (p. 102 of his monograph, second edition), “*We see that diversification is extremely powerful **when outcomes are uncorrelated.***” [emphasis added]

Unfortunately, during bear markets, everything becomes highly correlated. As a result, diversification fails you right when you need it the most.

As a simple example, take the Global Financial Crisis of 2008. Markowitz and Modern Portfolio Theory suggest that you should have a diversified mixture of investments that have low correlation to one another. Mathematically, this is a great concept but only so long as those correlations remain constant.

The chart below shows several different asset classes that many include in a portfolio for the alleged diversification benefits. Yet, as can be seen, in 2008, their performance was eerily similar (i.e. they became very correlated). If you were holding this diversified mixture of investment assets, this “diversification” did you no good in 2008.



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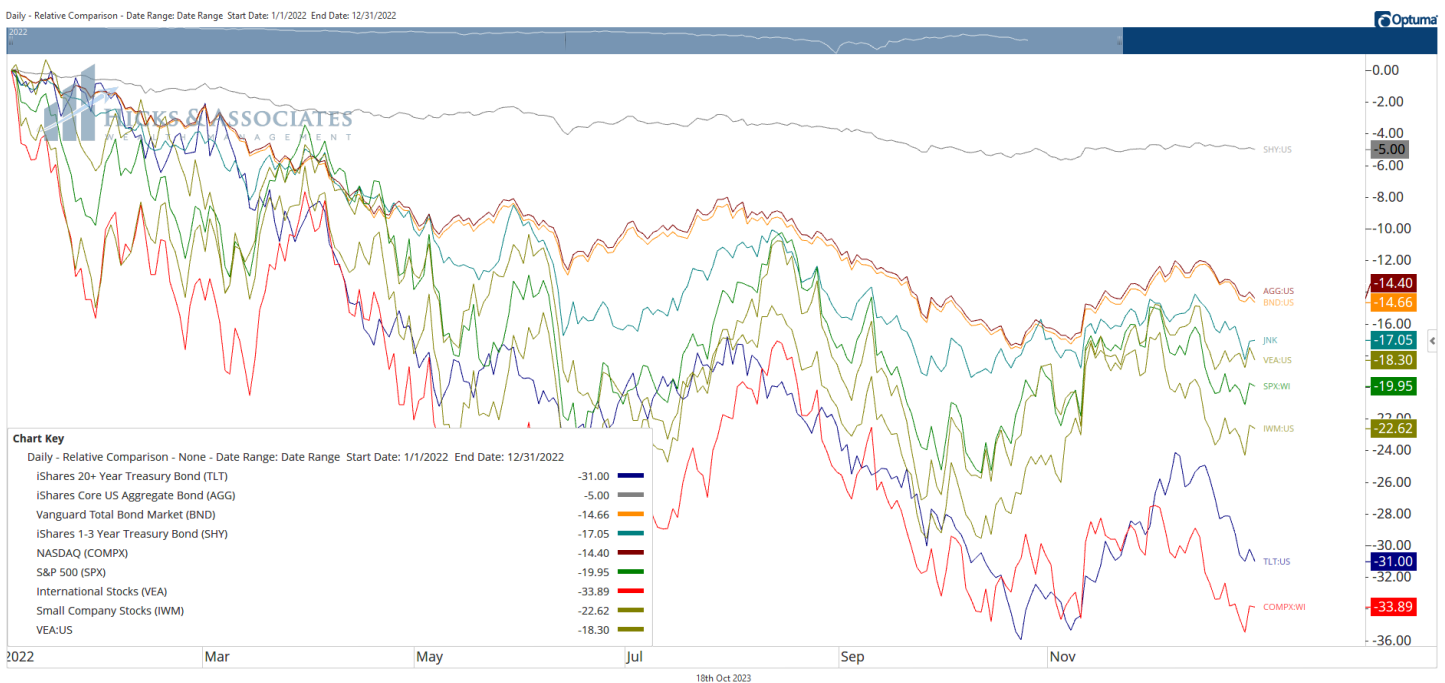


Diversification Will Not Save You

A savvy reader might quip, “But this chart does not include any fixed income assets. A diversified portfolio would include some bonds too.”

Fine. Point taken.

Here’s a look at several asset classes—this time including fixed income—and how they performed in 2022.



Did diversification help you in 2022?

Nope.

As a PhD dissertation, Markowitz’s paper was groundbreaking and his place in financial history is well deserved. However, since his work has been published, empirical evidence suggests that his theory is seriously flawed.

Measure Risk, Invest Accordingly

While Modern Portfolio Theory definitely has its flaws, we recognize that Markowitz had the same objective we do for our clients: maximize returns, minimize risk.

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So how do we approach the problem?

Our solution is to look at investing in a manner similar to driving. In certain circumstances, we want to drive with the throttle wide open. In some environments, we want to drive cautiously. In different environments, we will keep the car parked in the garage.

We go about this by utilizing a “weight of the evidence” approach. There are many different ways to measure whether or not we are likely to be rewarded for taking risk⁶. We take 14 different technical indicators and combine them into one proprietary risk indicator that we call the Vertical Speed Indicator or VSI.⁷

The chart below shows a monthly candle chart for the S&P 500. Each candle represents a month in the stock market. Each candle is color coded to coincide with our VSI. When 60% or more of the individual VSI components point to a “risk on” environment, the candle is green. When 40% or less of the individual VSI components point to a “risk on” environment, the candle is red. When the VSI is between 40% & 60%, the candle is orange.

To return to the driving analogy, green is “go”, red is “stop” and orange is “proceed with caution”.



⁶ This is another point of contention with Modern Portfolio Theory. MPT uses standard deviation as a measure of risk. But if you understand math, that means that **upside** volatility and **downside** volatility are given the same weight. We have never once met a client who was offended by upside volatility.

⁷ I am a pilot and an aviation enthusiast. In a cockpit, one of the instruments on a pilot’s instrument panel is a Vertical Speed Indicator. I had to name my proprietary risk indicator something, so I gave a nod to my love of flying.

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We utilize our proprietary VSI, along with other tools, to shape the investment decisions we make on behalf of our clients and the money that we manage for them. While we still need to point out that past performance is no guarantee of future results, we will also point out that we will not blindly invest our clients' hard earned money hoping that we are in a "long term" environment that is conducive to growing wealth. We believe the duty of a fiduciary is to first protect the clients' wealth.

As we stated at the outset, while we want to make money in the long term, sometimes, that means surviving the short term.

To Learn More

If you would like to learn more about how we manage money for our clients, click the Contact Us button on our website: [Hicks-Associates.com](https://www.hicks-associates.com).

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Theodore Hicks began his financial planning and asset management career in February 1999 by joining one of the nation’s largest financial planning and advice firms. In 2020, Hicks and his team broke away to join an independent Registered Investment Advisory (RIA) firm. Two years later, when other professional advisors started indicating interest in hiring Hicks to sub-advise for the assets under their care, Hicks launched Hicks & Associates Wealth Management, LLC an SEC Registered RIA. Today, Hicks’ serves at the Chief Executive Officer and Chief Investment Officer where he oversees the firm’s proprietary multi-strategy investment approach. Hicks & Associates Wealth Management is based in Cary, NC where Hicks resides with his wife and three children.

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