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Financial Briefs

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Dow Theory: Curbing Emotional Investing

In addition to starting the company that publishes *The Wall Street Journal*, Charles Dow (1851–1902) also lent his name to one of the most popular U.S. stock market indexes (the Dow Jones Industrial Average) and created a theory regarding major shifts in stock market trends. While neither Dow nor those who refined the Dow theory after him believed they were creating a surefire way to beat the market, they did believe that following its principles could at least avoid the mistakes associated with greed and fear.

Three Assumptions

Behind the Dow theory is a set of assumptions about how the stock market works:

- **The stock market moves in broad cyclical trends.** According to Dow, there are primary trends, which are long lasting (from months to years), and minor trends, which don't last long and run in the opposite direction of the primary trend. Primary up trends are bull markets and primary down trends are bear markets — these are marked by peaks and troughs in price charts. Within these broader trends, there are secondary (minor) countertrends called corrections, which can retrace anywhere from 33% to 67% percent of the primary trend's movement. Of course, no one ever knows in advance how long trends will last (that's a key principle of the Dow theory). And since market prices fluctuate from day to day, it's dangerous to make too much out of a single day's movement.
- **Primary trends can't be manipulated.** While it may be possible for private interests to manipulate the price of one security for a relatively short period of time, the Dow theory holds that the primary trend in the stock market is driven by forces much bigger than any single individual, cartel, breaking news, or rumor.
- **The stock indexes reflect all available information.** The Dow theory believes that everything there is to know about a stock and the economy at a given moment is factored into the prices of stocks. This include hopes, fears, and expectations of such factors as interest rates, earnings,

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When Should You Sell?

Most information about stock investing seems to discuss buying, but to actually profit from a stock investment, it must be sold. For many investors, selling a stock is the most difficult decision.

The reason selling is difficult for some investors is the fear of missing out on future profits. Let's say an investor purchases a stock at $30 per share and decides to sell when the stock reaches $35 per share. But when the stock reaches $35, the investor thinks it is doing so well that it will surely rise more. The stock then drops to $31 and the investor decides to wait until it reaches $35 again. Then the stock takes another tumble to $24 and the investor just lost all the profit, plus some of the initial investment.

If selling is dictated by emotion rather than a well-thought-out plan, it is very likely to play out as described in the example above. A good selling decision may leave some profit on the table, but it should be determined by a rational analysis of valuation and price. The most successful investors do not focus on market timing by trying to sell at the highest price; instead, they focus on buying at one price and selling at a higher price.

If you have a difficult time with selling, you should consider using a limit order. This type of order will

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Dow Theory

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revenue, and product initiatives. Unexpected events can occur, but usually they affect the short-term trend, creating what are called reaction rallies. These soon lose steam and the primary trend resumes.

Three Primary Trend Phases

According to the Dow theory, major trends consist of three phases of varying length:

Stage 1: Accumulation or distribution. In this phase, the smart money — typically large institutional investors like investment banks, pension funds, and mutual funds — start major buying or selling programs. Initially, this looks like a secondary countertrend, but trading volume on the major exchanges noticeably increases on up days, while volume tends to be lighter on down days. In a bull market, stocks are cheap, but no one other than value investors seems to buy them. In a bear market, there's a high level of enthusiasm for stocks, and few people believe the bull market is over.

Stage 2: The big move. In this phase, there are many more days in which the indexes move in the direction of the primary trend than in the opposite direction. In bull markets, there are strings of up days, followed by shorter strings of down days, reflecting the spread of enthusiasm for stocks. In bear markets, the opposite occurs, as anxiety and pessimism mounts. The result is a significant, long-term increase (bull markets) or decrease (bear markets) in the market averages.

Stage 3: Excess. The final phase of a primary trend is marked by extremely high levels of emotion — enthusiasm in bull markets and pessimism in bear markets — which are signs that the primary trend is about to change. These extremes can be seen in the behavior of individual investors: in bull markets, even the most conservative investors are buying stocks. On the other hand, in the excess stage of a bear market, everyone is concerned about safety of principal, while those who bought stocks at high prices have finally given up and sold at a loss.

The Indexes Confirm the New Trend

For Charles Dow, the primary trend was reflected in the Dow Jones Industrial Average, which today comprises 30 stocks. But Dow also looked to another index to confirm the emergence of a new trend. In his day, that was the Dow Railroad Index. Today, it's the Dow Transportation Index of 20 companies engaged in the shipping and transportation of manufactured goods, including marine transport, railroads, and trucking. The idea was a true change in the trend of business activity in the big manufacturing firms would show up in business for the companies that move the goods they make.

For the second index to confirm the first, the Dow theory looks for both averages to be moving in the same direction. New highs or lows in one index are accompanied by highs or lows at the same time or shortly thereafter in the other.

The Dow theory isn't intended to help short-term traders. What it's designed to do is tip off long-term investors to changes in the trend, so they can shift their money from stocks to another asset class, like bonds or cash, during a full business cycle.

Please call if you'd like to discuss this in more detail.

Learning Lessons from the Stock Market

If you pay attention to the stock market, you can learn some valuable lessons:

- **The market tends to revert to the mean.** When the stock market has an extended period of above or below average returns, it has a tendency to revert back to the average return.
- **Don't chase performance.** Investors often move out of sectors that are not performing well, moving money to investments that are currently high performers. But the market is cyclical, and often those high performers are poised to underperform, while the sectors just sold are ready to outperform. A classic example is technology stocks in early 2000.
- **Avoid strategies designed to get rich quick.** The stock market is a place for investment, not speculation. When your expectations are too high, you have a tendency to chase after high-risk investments.
- **Don't avoid selling a stock because you have a loss.** When selling a stock with a loss, an investor has to admit that he/she made a mistake, which is psychologically difficult to do. When evaluating your stock investments, objectively review the prospects of each one, making decisions to hold or sell on that basis.
- **Make sure an investment will add diversification benefits to your portfolio.** It's common for investors to keep adding investments that are similar in nature. This does not add much in the way of diversification, while making the portfolio more difficult to monitor.
- **Check your portfolio's performance periodically.** Compare your actual return to your targeted return. Now honestly assess how well your portfolio is performing. Are major changes needed?
- **No one knows where the market is headed.** So don't pay attention to gloomy or optimistic predictions. Instead, approach investing with a formal plan so you can make informed decisions with confidence.

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automatically sell the stock when it reaches your target selling price.

When to Sell

You should decide when to sell a stock at the time of purchase. Following are examples when you should consider selling based on your personal financial situation, as well as warning signs with the companies you are invested in:

- If you are losing sleep over a particular investment, it may be worth reducing your emotional distress to sell even at a small gain or loss.
- If you need money in the next three years to purchase a home or send a child to college, you should pull the money out while you know you have it.
- To help reduce tax payments, you may want to look for investment losses to offset other gains.
- If your portfolio is shifting from your original asset allocation, you will want to rebalance it to get back on track.
- Watch your stocks for a high price/earnings (P/E) ratio, which compares the company's recent earning to its stock price. If the P/E ratio is high, it can be an indicator that the stock is overpriced.
- Keep an eye on the company's competitive advantage. If others have come up with a new product or technology, they can erode their market share.
- If the company makes a drastic change in direction or management, it may indicate a problem with its business model. Research the changes and follow your instincts about the company's future.
- If a company's sales are falling, it may be signaling a problem. While all companies will go through slumps, if other competitors are experiencing growth during the same time period, it may be time to sell.
- When there is a trend of shrinking profits, it means the company's expenses are rising faster than its revenues, and it's having a hard time keeping profits up.
- If a company cuts its dividend payment, it may be a signal that it is expecting lower earnings and less growth.

Please call if you would like to discuss this topic in more detail.

Principles of Stock Diversification

Diversification is a practice that investors use to reduce risk and maximize returns by investing in various industries that will most likely react differently to the same event in the market.

When investing, there are two types of risk one faces:

- **Undiversifiable** — Also known as systematic or market risk, this is risk that all companies are exposed to and includes inflation, interest rates, exchange rates, political instability, etc. This risk is just the price of doing business, as all investors must assume it.
- **Diversifiable** — Also known as unsystematic risk, this is risk that can be specific to a company, industry, market, or country. Diversification can help manage and reduce this risk.

How to Diversify

Most experts agree that diversification is extremely important to reaching long-term goals while mitigating risk. A properly diversified equity portfolio should hold stocks from different industries, company sizes, valuations, growth rates, and countries to help reduce volatility and limit exposure to a permanent loss of capital.

The more uncorrelated the stocks in your portfolio are, the more you are limiting your risk exposure.

Let's say you have a portfolio of only automotive stocks and it appears there will be a strike. Most likely, all of the automotive stocks will experience some drop in their share prices, and in turn, you will see a noticeable drop in value.

However, if you have stocks in other industries that are performing well, you will be able to offset some of that loss and some of the mental anguish that goes along with it.

How Many Stocks Should You Own?

While there is always debate about how many stocks to own in a well-diversified portfolio, most experts agree that 15 to 20 stocks across different industries is optimal. This portfolio size is manageable, yet it allows you some room for losses.

The other extreme is overdiversification where investors hold too many stocks, which makes it almost impossible to know the companies well. Not being knowledgeable about your stock investments can lead to making irrational decisions, which will negatively impact your portfolio returns. The key is to strike an appropriate balance.

Another impact of overdiversification is that an investor can become indifferent regarding his/her investment decisions. If you're holding over 100 stocks, any individual stock might represent only a small percentage of the total portfolio. If the stock turns out to be a loser, it won't cost you very much; but if it provides great returns, you won't reap the benefits either.

Diversifying your stock portfolio will help you manage the risk of the price movements of your assets, but it can't completely eliminate risk and volatility. Please call if you'd like to discuss diversification in more detail.

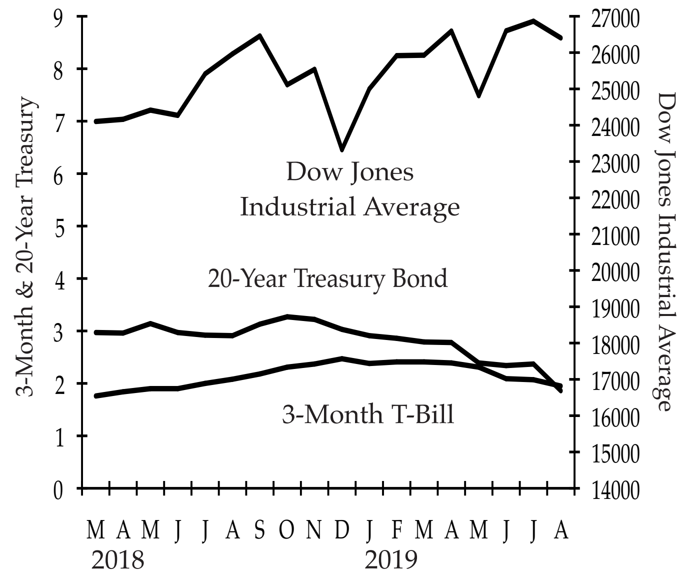
Business Data

Indicator	Month-end Jun-19	Jul-19	Aug-19	Dec-18	Aug-18
Prime rate	5.50	5.50	5.25	5.50	5.00
3-month T-bill yield	2.09	2.07	1.95	2.47	2.08
10-year T-note yield	2.05	2.07	1.58	2.89	2.83
20-year T-bond yield	2.34	2.37	1.86	3.03	2.91
Dow Jones Corp.	3.22	3.21	2.86	4.40	3.84
GDP (adj. annual rate)#	+2.20	+3.10	+2.00	+2.20	+4.20

Indicator	Month-end Jun-19	Jul-19	Aug-19	% Change YTD	12-Mon.
Dow Jones Industrials	26599.96	26864.27	26403.28	13.2%	1.7%
Standard & Poor's 500	2941.76	2980.38	2926.46	16.7%	0.9%
Nasdaq Composite	8006.24	8175.42	7962.88	20.0%	-1.8%
Gold	1409.00	1427.55	1528.40	19.3%	27.1%
Unemployment rate@	3.60	3.70	3.70	0.0%	-5.1%
Consumer price index@	256.09	256.14	256.57	1.8%	1.8%

— 4th, 1st, 2nd quarter @ — May, Jun, Jul Sources: *Barron's, Wall Street Journal*
Past performance is not a guarantee of future results.

18-Month Summary of Dow Jones Industrial Average, 3-Month T-Bill & 20-Year Treasury Bond Yield
March 2018 to August 2019



News and Announcements

How Much of Your Portfolio Should Be in Stock?

One of the most often asked questions is how much of a portfolio should consist of stocks. It's a good question, and one that doesn't always have a clear-cut answer. The amount of stocks you should have in your portfolio will vary depending upon a number of different factors, including your age, current net worth, and penchant for taking risks. Still, there are a few basic rules of thumb that are worth adhering to, which should make fleshing out your portfolio less stressful.

If you're saving for retirement, most financial planners will recommend that the younger you are, the more of your portfolio should be allocated to stocks. Stocks are a relatively risky and volatile form of investment. When we're young, taking risks tends to come along with less catastrophic consequences than when we're nearing retirement age. If formulas work for you, the general idea is to subtract your age from the number 100 to wind up with a safe percentage of stocks versus other investments. For example, 30-year-olds will often do well by allotting 70% of their portfolios to stocks, while 60-year-olds may want to reduce this percentage to 40%.

Of course, age is just one factor that influences portfolio allocations, and there are more aspects that need to be taken into consideration. The best way to ensure your portfolio is properly divided is to work with a financial planner who is fully aware of your situation and can make educated suggestions. After all, a formula can only get you so far, and personal recommendations will always be more valuable than guesswork.

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