ICR® 3rd Quarter Newsletter – October 2017

In the face of escalating geopolitical tensions, devastating natural disasters, and the Federal Reserve's decision to begin normalizing monetary policy, the S&P 500 still managed to gain almost 4% in the third quarter. The technology sector once again led the way with an 8.6% gain and now boasts a 27.4% gain for the year. The only sector to show a negative return for the quarter was consumer staples with a modest 1.3% loss. Energy (-6.6%) and telecom (-4.7%) are the only two sectors with losses year-to-date, even after both posted 6.8% gains in the third quarter. Emerging markets continued their strong run for the year, posting an 8% gain in the third quarter, while developed foreign markets also gained 5.5%.

Low volatility was once again a major theme in the markets. The VIX (an index that measures market volatility) briefly spiked in mid-August but quickly returned to its lower levels. That spike in volatility was largely attributed to increased tension with North Korea which was met with a short term sell-off in the markets. Prior to that brief August hiccup, the S&P 500 hadn't moved more than 0.3% in either direction for fifteen straight trading days – an unprecedented streak of extremely low volatility in the markets.

In bond markets, the low-volatility story wasn't much different, as the ten-year Treasury yield ended the quarter at 2.33%, just .03% higher than it started. The Federal Reserve left the federal funds rate unchanged for both their July and September meetings, but did announce that they would begin unwinding their balance sheet which had grown to almost $4.5 trillion in the wake of the financial crisis. Almost nine years after the advent of the Fed's massive stimulus program to bolster the struggling economy, this announcement signals their confidence in the current strength of the economy.

Behavioral Finance – Emotions and Money

Earlier this month, economist Richard Thaler was awarded the Nobel Prize in Economic Sciences "for his contributions to behavioral economics." Economic theories have historically assumed that humans act rationally to maximize their wealth, happiness, or whatever else their goal may be. Thaler argued that, while those theories are perhaps useful for describing how humans *should* act, they often fail to account for how humans *actually* act. So, Thaler sought to reconcile economic theory with certain aspects of psychology to gain a better understanding of how people make decisions and what could be done to help them make better decisions.

Thaler advanced a concept known as "choice architecture," in which people's behavior can be changed by the manner in which choices are presented to them. One of his most famous and lasting contributions involved the finding that when employees are automatically enrolled in their company's 401(k) plan, they are more likely to continue to participate in it. In addition, if they are automatically enrolled in a program that systematically increases their 401(k) contributions over time, they tend to save more and end up with more money when they retire. The employees could opt out of these programs at any time, but most chose not to do so, likely for the same reason some never sign up in the first place: the status quo bias. Call it laziness if you will, but humans have a bias toward inaction. In the 401(k) example, Thaler was able to utilize this bias to create a more favorable outcome.

The status quo bias is one of a number of emotional biases in human behavior that can affect our ability to make rational investment decisions. We want to take a brief look at a few more and how we at ICR attempt to overcome them.

Confirmation bias: the tendency to seek out and interpret new evidence supporting our initial beliefs while ignoring contradictory evidence. We've all seen this take place when it comes to politics, as it's natural to watch and read those political commentators with whom we most agree, and subsequently solidify the views that we already held. The same can be true when an investor likes a particular security or asset class. This is why it's part of our mantra at ICR to always ask ourselves, "What if we're wrong?" We understand the dangers of confirmation bias and try to avoid it by actively seeking out information and news that contradicts our own view.

Hindsight bias: the tendency to remember that our forecasts were better than they really were; otherwise known as the "I knew it all along" effect. This can be dangerous because it causes investors to focus on their successful prognostications and forget about all the others that turned out to be incorrect. This, in turn, leads to overconfidence in one's ability to forecast the future. At ICR, we are constantly asking ourselves where we were wrong about something, what led us to be wrong, and if there's a way to avoid that path in the future. For any investor, we believe it's important to focus on a prudent process rather than hunches or instincts.

Loss aversion: humans feel the pain of losing $1 more than they feel the joy of gaining $1. Thaler said, "The ability to tolerate stock market risk is an inverse function of the frequency of checking on performance." Indeed, it is painful to see a loss, but this can lead some investors to throw in the towel when the cumulative emotional effect of small losses is enough to deter them from participating in future gains. At ICR, we aim to construct portfolios that our clients can stick with over the long run. Short term losses are inevitable, but if we can limit those losses, we think our clients stand a better chance of adhering to their investment plan and meeting their financial goals.

Thank you for your continued confidence and support as we work to prudently grow your wealth and avoid the many potential pitfalls of investing. Please call us if you have questions or concerns.

Sincerely,

James A. Heine

James L. Cobb

Market Report (as of 9/30/17)

Index	2017 YTD (%)	3-Year Annualized (%)	5-Year Annualized (%)
S&P 500	12.53	8.50	11.82
Dow Jones Industrial Average	13.37	9.54	10.76
U.S. Aggregate Bond Index	3.15	2.71	2.06
MSCI EAFE (Foreign Index)	17.21	2.25	5.49