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Perhaps you've heard it or felt it, but fear of financial market decline has become palpable among the public. It's not just fear as reflected by TV shows or internet social media I'm talking about, but fear reflected by real people in conversation. I travel rather extensively, speaking to both advisors and their clients, and hear directly from the public such fear of a stock market collapse. The advisors report, and the clients confirm, that it's the norm for their clients to hold more than 20% of their *investable* assets in cash. Considering that cash now earns sub-1% yields, there really isn't an investment reason to hold such a high proportion of one's investments in cash unless one fears a financial panic.

Is such a panic likely? Well, I cannot predict the future, but as one who has been advising investors for over 38 years and studying the stock market for longer, market declines rarely begin with such prevalent pessimism. Major stock market declines proceed from periods of extraordinary optimism about the future, when seemingly no one can imagine that the economy and the market do anything but surge ahead. Public sentiment clearly is not at that point.

But didn't the market recently hit an all-time high? Yes, but that's not a predictor of market decline. The stock market's price regularly hits all-time highs because the economy is growing virtually every year. It was Warren Buffet who once noted that a bank certificate of deposit whose interest is compounded daily hits an all-time high every day! The market *should* be marching ahead similarly, as long as the economy and the businesses undergirding it are growing, and they are.

But isn't the market's price-to-earnings (P/E) ratio rather high? Yes, as it has been for most of the last 20 years. The reason for the high P/E ratio (and other high valuation measures) is that inflation is very low. Inflation "steals" away investment returns by paying you back in dollars that are worth less than you originally invested. Thus, in a rising inflation environment, the market eventually corrects for this "theft" by valuing stocks at lower P/E ratios. On the flip-side, when inflation is low (as it has been for over 20 years), after-inflation returns are better than expected because very little of this "theft" occurs. Therefore, stocks adjust by trading up to higher P/E ratios because investors become confident that they'll actually get to keep their returns. We wrote last quarter of some things that make us worry about inflation, but we are not seeing it "perk up" yet.

So, we've got nothing to worry about? No, there are always things to worry about, but economic disaster is usually not a high probability item, and we don't think it is today, either. But all the financial markets are the products of human decisions and, as a result, emotions can become embedded in those decisions and thus into prices. A 5 to 10 percent decline in stock prices never surprises us any more than a similar rise; it happens every year. The "sentiment pendulum" of optimism/pessimism can swing rather widely and quickly, much more quickly, in fact, than the economy moves. Rather than being "swung around" by this pendulum, a wise investor should take advantage of the swings. This is what we seek to do: take advantage of excessive pessimism and optimism in the markets.

We appreciate your confidence in us.

Gratefully,

Mark A. Keller, CFA
CEO and Chief Investment Officer