Statistically, the chances that a river will rise as high as the 100-year flood stage in a given year is 1 in 100. But, just because a 100-year flood happened last year doesn’t mean that it won’t happen this year. In other words, future rainfall and floods don’t depend on what happened in the past. As an example, in September 2018, Wilmington, NC received 23.01 inches of rainfall in a few days, an amount typically not expected over months, never mind days.¹ No amount of planning would likely have considered such rainfall in such a narrow window of time.

Today, we think that financial markets are at an inflection point, as darkening clouds start to appear with increased frequency. Equity markets have rallied, largely owing to the Federal Reserve’s about-face on its tightening policy combined with economic data still being supportive of U.S. growth. However, investors were reminded late last year, and even more recently in early May, that volatility, a dynamic thought dormant in the market given a river of positive economic data, can still shock people. How quickly that veneer of stability was torn away can be seen in Exhibit 1, which captures the sudden flood waters that surprised investors in December.

**Exhibit 1: Volatility can spike up when you least expect it**
CBOE Volatility (VIX) Index ending 5/13/19

Source: Bloomberg, 5/13/19.

¹ Source: National Weather Service, Wilmington, NC.
Feeling the pain of down markets

Spikes in market turmoil, or what pundits refer to as volatility, are defined as dispersion around the mean, that is, how quickly up or down markets move away from their longer-term averages. This dynamic can have a powerful effect on an investor’s emotions because it also represents a deviation from the current value of their holdings. Since volatility is often associated with negative performance in equity markets, it commonly equates to an investor feeling that a portion of their wealth has been lost. That impact (or pain) can often have twice the emotional effect that gains might have;² hence, investors tend to be more sensitive to sharp, negative changes in financial markets than they may otherwise believe.

Three paths diverge in a wood ...

The hypothetical scenario illustrated in Exhibit 2 shows an investor with a 10% goal over a period of time between Point A and Point B. The investor can invest in portfolios that are cash, single risky asset class (i.e., stocks) or multi-asset approach (i.e., 60% equity/40% fixed income portfolio) and does not need their capital during the period. Each investment path starts and ends at the same point, delivering the same return over the journey. Which offers the “best” solution? Almost invariably, investors tend to select cash as the preferred option, perhaps owing to some people remembering their high school geometry lesson that stated that the shortest distance between two points is a straight line. Theoretically, the actual choice does not matter as the investor has achieved their targeted return. Additionally, volatility is not an issue because access to the invested capital is not required and the stated goal was met. But investing decisions do not occur in vacuums. Instead, investors are surrounded by distractions and face their own human tendencies.

Exhibit 2: An emotional journey

Three hypothetical approaches to investing for the long term

<table>
<thead>
<tr>
<th>Time</th>
<th>Cash</th>
<th>Single risky asset class</th>
<th>Multi-asset approach</th>
</tr>
</thead>
<tbody>
<tr>
<td>Point A</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Inflection point</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Point B</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: Foresters Financial. For illustration purposes only. Single risky asset class is considered to be any equity capitalization category. Multi-asset approach is a 60% equity/40% fixed income portfolio.

Our appetite for risk and volatility faces several challenges which we highlight below. As described below, navigating markets can be a very difficult thing to successfully achieve, with the added complications of spontaneous, idiosyncratic events occurring that are often challenging, if nearly impossible, to anticipate.

**Investor challenge #1: Information overload**

As investors, we are bombarded by the media with financial information on a seemingly second-by-second basis. And as Robert Shiller has pointed out, there is an interesting connection between the press, financial markets and audiences as the "history of speculative bubbles begins roughly with the advent of newspapers." This suggests that there is a certain amount of culpability by the media in fanning market frenzies. Furthermore, we have observed that many people trade in and out of their holdings at inopportune moments. These investors are often subject to "noise" from the media and make unfair comparisons for their own portfolios. This mindset often leads to selling positions at times that are frequently the most inappropriate occasions to be shedding assets. Unfortunately, it seems that many people will always include external, non-relevant factors in their assessments of the market. Professional management of an investor's assets can remove a number of these issues.

<table>
<thead>
<tr>
<th>Scenario #1</th>
<th>Scenario #2</th>
<th>Scenario #3</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Cash</strong></td>
<td><strong>Single risky asset</strong></td>
<td><strong>Multi-asset approach</strong></td>
</tr>
<tr>
<td>Return</td>
<td>10.0%</td>
<td>10.0%</td>
</tr>
<tr>
<td>Theoretical happiness</td>
<td>😊</td>
<td>😊</td>
</tr>
<tr>
<td>Investor reaction</td>
<td>But no upside 😞</td>
<td>Lost a lot of gains/under diversified 😞</td>
</tr>
</tbody>
</table>

Source: Foresters Financial. For illustrative purposes only. 😞 = indifferent; 😊 = happy; 😞 = unhappy

Our appetite for risk and volatility faces several challenges which we highlight below. As described below, navigating markets can be a very difficult thing to successfully achieve, with the added complications of spontaneous, idiosyncratic events occurring that are often challenging, if nearly impossible, to anticipate.

**Investor challenge #2: Emotional investing**

How we feel about our investments changes over time as we naturally compare ourselves to the wider market and our peers. Despite the three investment paths landing at the same endpoint in our earlier example in *Exhibit 2*, the journey experienced by the risky asset class and multi-asset approach changes over time. Those invested in a cash experienced a fairly "boring" journey with no sharp movements and no surprises but were left "underperforming" the single risky asset until the inflection point occurred. When the single risky asset suffered a severe drawdown, cash was an attractive place to be. Had the investor been in the former, they would have doubled their money at one point and probably felt very happy they hadn’t invested in cash or a multi-asset approach (see *Exhibit 3*). That changed abruptly when nearly all the gains were wiped away. While the multi-asset approach lagged the single risky asset in the strong up market and experienced some drawdowns (which is actually intrinsic to the strategy’s design), it delivered the stated return with less ups and downs than the single risky asset. Finally, investors can be slow to re-enter the market, perhaps feeling "burnt" by their past experiences, thus losing out on attractive buying levels for stocks and bonds. This translates to losing on both ends—selling at lows and buying at highs.

**Investor challenge #3: Investor disconnect**

Many investors have been following a type of diversification strategy but, in our opinion, doing it incorrectly by attaching unfair, emotional comparisons to the approach. This can take the form of using an inappropriate benchmark or even changing benchmarks in the middle of a market cycle. Offering exposures to diverse asset classes and factoring in an investor’s risk tolerances, a true buy-and-hold strategy aims to mitigate the downside to challenging markets, while also allowing for prudent upside capture. Hence, the most relevant benchmark is used to capture the full length of an investor’s journey, not one for episodic events.
**Exhibit 4: Asset class underperformance**

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<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Average investor</td>
<td>-0.6</td>
<td>-0.7</td>
<td>-0.7</td>
<td>-0.7</td>
<td>-0.9</td>
<td>-0.7</td>
<td>-0.5</td>
<td>-0.6</td>
<td>-0.3</td>
<td>-0.9</td>
<td>-0.8</td>
</tr>
<tr>
<td>underperformance</td>
<td></td>
<td></td>
<td></td>
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<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Percentage of asset</td>
<td>95%</td>
<td>100%</td>
<td>95%</td>
<td>100%</td>
<td>100%</td>
<td>95%</td>
<td>82%</td>
<td>100%</td>
<td>64%</td>
<td>86%</td>
<td>95%</td>
</tr>
<tr>
<td>classes with investor</td>
<td></td>
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<td></td>
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<tr>
<td>return less than total</td>
<td></td>
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<tr>
<td>return</td>
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<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>S&amp;P 500 Volatility</td>
<td>15.3</td>
<td>3.9</td>
<td>10.3</td>
<td>13.7</td>
<td>8.3</td>
<td>8.5</td>
<td>10.5</td>
<td>15.9</td>
<td>19.3</td>
<td>22.3</td>
<td>21.0</td>
</tr>
</tbody>
</table>


**Exhibit 4** shows that since 2008, there have been four calendar years (highlighted in blue) in which every asset class that we examined underperformed the buy-and-hold strategy. In fact, over that same period, the average asset class underperformance was 67 basis points, which is a significant shortfall. Based on averaging the individual asset class returns, a buy-and-hold strategy has, on average, outperformed single asset classes over the period. This suggests that investors who focus on only one particular asset type might have enjoyed better annual returns if they had implemented a more diversified approach.

**Exhibit 5: High correlation between risk and investor outcomes**

One-year standard deviation and performance ending 3/31/19

Source: Morningstar, 3/31/19. Risk is defined as standard deviation. Investor outcome is measured by subtracting investor return from total return.
The costs of selling too soon

*Exhibit 5* illustrates the tradeoff between risk and investor outcomes, represented by standard deviation and total return minus investor return, respectively. The further to the top right area of the chart that an investor allocates, the riskier and potentially higher the return. As one might intuitively expect, the traditionally more conservative fixed income allocations appear in the bottom left, while the usually more aggressive equity portfolios dominate the risk-on profile.

Based on our experience, people tend to trade in and out of investments too frequently and are not successful in their quest to time the market. In fact, over the past year, there is a high correlation between the volatility of an asset class and the investor’s actual return, with higher volatility investments lagging lower volatility investments. Over the last 12 months, every asset class that we examined in *Exhibit 4* experienced worse investor returns than had the investor just remained invested. As many market observers noted during the fourth quarter of 2018 when the S&P 500 Index fell nearly 20% and volatility spiked, more risk means a higher likelihood of drawdowns.

Why adopt a diversified approach?

We think the diversified approach presents the ideal path for investors as it mitigates volatility, while still offering upside potential. The cash scenario, as shown earlier in *Exhibit 2*, while perhaps preferred by some given its lack of volatility, also offers zero upside. Essentially, the investor’s yield is capped. For someone with an extended investment horizon, such a limitation can leave them woefully unprepared for their future financial needs. In our opinion, this is not the best approach for long-term investors.

An additional benefit of a multi-asset approach is that it can be thought of as a buy-and-hold strategy in which a professional investment manager determines the most suitable assets across a longer-term investment horizon that has a shorter-term tactical component embedded within it.

How to build a truly balanced investment approach

The following steps should be considered as a starting point for a truly balanced and risk-adjusted approach to investing:

- Start the investment process with a timeline based on how long the investor is planning on remaining invested
- Determine the investor’s return target
- Determine the investor’s risk tolerance
- Decide on the investor’s need to access capital during this timeframe. If none is required, then we recommend that the investor trust their investment advisor and ignore the “noise” from media outlets as well as friends and family.

Summary

To our way of thinking, the reason that investors insist on trading in and out of positions, instead of sitting passively on the sidelines and allowing their investments to simply ride through an economic cycle, is due largely to emotional attachments, meaning fear and a touch of greed coupled with the confidence that they can successfully time financial markets. Based on the data and our experience, we think this is a less than optimal investment approach. A steady hand on the investment tiller when the flood waters rise can be an invaluable resource to an investor. We recommend that investors find a financial advisor that they trust. Then, they ought to develop a suitable plan based on their customized goals and risk parameters, and let the advisor steer the boat.

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All investing involves risk, including possible loss of principal. Equities are subject to market risk (the risk that the entire stock market will decline because of an event such as deterioration in the economy or a rise in interest rates), as well as special risks associated with investing in certain types of stocks, such as small-cap, global and international sectors. International investments may be volatile and involve additional expenses and special risks including currency fluctuations, foreign taxes and geopolitical risks. Emerging and developing markets may be especially volatile. Fixed income investing includes interest rate risk and credit risk. Interest rate risk is the risk that bonds will decrease in value as interest rates rise. As a general rule, longer-term bonds fluctuate more than shorter-term bonds in reaction to changes in interest rates. Credit risk is the risk that bonds will decline in value as the result of a decline in the credit rating of the bonds or the economy as a whole, or that the issuer will be unable to pay interest and/or principal when due. There are also special risks associated with investing in certain types of bonds, including liquidity risk and prepayment and extension risk, or investing in high yield (junk) bonds. There are additional risks associated with the use of derivatives. Past performance does not guarantee future results.

The CBOE Volatility Index (VIX) is a popular measure of the stock market's expectation of volatility implied by S&P 500 index options, calculated and published by the Chicago Board Options Exchange (CBOE).

The Standard & Poor's 500 Index (S&P 500) is a capitalization-weighted index of 500 stocks. The Index is designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

The Dow Jones Industrial Average (DJIA) is a price-weighted average of 30 significant stocks traded on the New York Stock Exchange (NYSE) and the NASDAQ.

Investors cannot invest directly in an index. Indexes are unmanaged and do not reflect the performance of any particular security.

Standard deviation is a statistical measure of the historical volatility of a mutual fund or portfolio, the higher the better, other than the greater the risk.

Large-blend portfolios are fairly representative of the overall U.S. stock market in size, growth rates, and price. Stocks in the top 70% of the capitalization of the U.S. equity market are defined as large cap. The blend style is assigned to portfolios where neither growth nor value characteristics predominate. These portfolios tend to invest across the spectrum of U.S. industries and own their broad exposure. The portfolio returns are often similar to those of the S&P 500 Index. Large-growth portfolios invest primarily in big U.S. companies that are projected to grow faster than other large-cap stocks. Stocks in the top 70% of the capitalization of the U.S. equity market are defined as large cap. Growth is defined based on fast growth (high growth rates for earnings, sales, book value, and cash flow) and high valuations (high price ratios and low dividend yields). Most of these portfolios focus on companies in rapidly expanding industries. Tactical Allocation portfolios seek to provide capital appreciation and income by actively shifting allocations across investments. These portfolios have higher turnover than bond sectors on a frequent basis. To qualify for the tactical allocation category, the fund must have minimum exposures of 10% in bonds and 20% in equity. Next, the fund must historically demonstrate material shifts in sector or regional allocations either through a gradual course of action or through a series of material shifts on a quarterly basis. Funds in allocation categories seek to provide both income and capital appreciation by investing in multiple asset classes, including stocks, bonds, and cash. Allocation—70% to 85% Equity portfolios are dominated by domestic holdings and have equity exposures between 70% and 85%. Allocation—50% to 70% Equity portfolios are dominated by domestic holdings and have equity exposures between 50% and 70%. Allocation—30% to 50% Equity portfolios are dominated by domestic holdings and have equity exposures between 30% and 50%. Allocation—15% to 30% Equity portfolios are dominated by equity investments in foreign stocks and have equity exposures between 15% and 30%. The typical mid-cap blend portfolio invests in U.S. stocks of various sizes and styles, giving it a middle-of-the-road profile. Most shy away from high-priced growth stocks but aren't so price-conscious that they land in value territory. The U.S. mid-cap range for market capitalization typically falls between $1 billion and $8 billion and represents 20% of the total capitalization of the U.S. equity market. The blend style is assigned to portfolios where neither growth nor value characteristics predominate. Small-blend portfolios favor U.S. firms at the smaller end of the market—capitalization range. Some aim to own an array of value and growth stocks while others employ a discipline that leads to holdings with valuations and growth rates close to the small-cap averages. Stocks in the bottom 10% of the capitalization of the U.S. equity market are defined as small cap. The blend style is assigned to portfolios where neither growth nor value characteristics predominate. Foreign small/mid-blend portfolios invest in a variety of international stocks that are smaller. These portfolios primarily invest in stocks that fall in the bottom 30% of each economically integrated market (such as Europe or Asia ex-Japan). The blend style is assigned to portfolios where neither growth nor value characteristics predominate. Foreign large-blend portfolios invest in a variety of big international stocks. Most of these portfolios divide their assets among a dozen or more countries, including Japan, Britain, France, and Germany. These portfolios primarily invest in stocks that have market caps in the top 70% of each economically integrated market (such as Europe or Asia ex-Japan). The blend style is assigned to portfolios where neither growth nor value characteristics predominate. These portfolios typically will have less than 20% of assets invested in U.S. stocks. Foreign large-blend portfolios invest in a variety of big international stocks. Most of these portfolios divide their assets among a dozen or more countries, including Japan, Britain, France, and Germany. These portfolios primarily invest in stocks that have market caps in the top 70% of each economically integrated market (such as Europe or Asia ex-Japan). The blend style is assigned to portfolios where neither growth nor value characteristics predominate. These portfolios typically will have less than 20% of assets invested in U.S. stocks. Diversified emerging-markets portfolios tend to divide their assets among 20 or more nations, although they tend to focus on the emerging markets of Asia and Latin America rather than on those of the Middle East, Africa, or Europe. These portfolios invest predominantly in emerging market equities, but some funds also invest in both equities and fixed income investments from emerging markets. Global Bond – USD Hedged funds invest in a diversified portfolio of principally investment grade bonds in a range of currencies and normally hedge their currency exposure back into USD. High-yield bond portfolios concentrate on lower-quality bonds, which are riskier than those of higher-quality companies. These portfolios generally offer higher yields than other types of portfolios, but they are also more vulnerable to economic and credit risk. These portfolios primarily invest in U.S. high-income debt securities where at least 65% or more of bond assets are not rated or are rated by a major agency such as Standard & Poor’s or Moody’s at the level of BB (considered speculative for taxable bonds) and below. Broad-basket portfolios can invest in a diversified basket of commodity goods including but not limited to grains, minerals, metals, livestock, cotton, oils, sugar, coffee, and cocoa. Investment can be made directly in physical assets or commodity-linked derivative instruments, such as commodity swap agreements. Inflation-protected bond portfolios invest primarily in debt securities that adjust their principal values in line with the rate of inflation. These bonds can be issued by any organization, but the U.S. Treasury is currently the largest issuer for these types of securities. Corporate bond portfolios concentrate on investment-grade bonds issued by corporations in U.S. dollars, which tend to have more credit risk than government or agency-backed bonds. These portfolios hold more than 65% of their assets in corporate debt, less than 40% of their assets in non-U.S. debt, less than 35% in below-investment-grade debt, and durations that typically range between 75% and 150% of the three-year average of the effective duration of the Morningstar Core Bond Index. Bank-loan portfolios primarily invest in floating-rate bank loans and floating-rate below investment-grade securities instead of bonds. In exchange for their credit risk, these loans offer high interest payments that typically float above a common short-term benchmark such as the London Interbank Offered Rate, or LIBOR. Real estate portfolios invest primarily in real estate investment trusts of various types. REITs are companies that develop and manage real estate properties. There are several different types of REITs, including apartment, factory-outlet, healthcare, hotel, industrial, mortgage, office, and shopping center REITs. Some portfolios in this category also invest in real estate operating companies. Muni national long portfolios invest in bonds issued by various state and local governments to fund public projects. The income from these bonds is generally free from federal taxes. To lower risk, these portfolios spread their assets across many states and sectors. These portfolios have durations of more than 6.0 years (or average maturities of more than 12 years).

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