RETIREMENT
INVESTMENT ADVISORS, INC.

2925 United Founders Blvd.
Oklahoma City, OK 73112
(405) 842-3443
(800) 725-4530

2952 Via Esperanza
Edmond, OK 73013
(405) 246-0404

9300 John Hickman Pkwy.
Suite 504
Frisco, TX 75035
(972) 377-2850

www.TheRetirementPath.com

left to right: Brenda C. Bolander, Joe Bowie, Randy Thurman, Carol Ringrose Alexander, Chad Rudy, and Andrew Flinton

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, revenue, and product initiatives. Unexpected events can occur, but usually they affect the short-term

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Investing Is a Marathon

In counseling my clients, I frequently stress the need for them to set investment objectives. Similar to a goal of completing a marathon, my clients typically seek to meet certain financial goals. Perhaps your goals are to have a comfortable retirement, pay for your children's or grandchildren's college educations, ensure quality care for a family member, or leave a legacy to a charitable organization. Whatever your goals, it makes sense to have them in writing and share them with me as we periodically review your investments. By seeking professional guidance, your opportunities to meet these goals may be increased.

Investing also requires perseverance and discipline, just like training for a marathon. Take time to review your spending habits and budget to look for potential problem areas. Tune up your budget in areas that

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Dow Theory

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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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are out of line with your savings goals. Make regular contributions to your investment accounts, just like a runner continuously trains for a marathon. And remember, the hottest and most popular investments may not be appropriate for you, just like sprinting is not appropriate in a marathon.

Additionally, remember the financial markets aren't always kind. Be prepared for the bumps along the way, just as a runner deals with the inevitable aches and pains of training. By setting reasonable investment goals, using professional management, and patiently building a diversified portfolio, many investors can achieve the financial and emotional satisfaction of completing their own financial marathon.

Stay Focused and Patient

How should you as an investor deal with volatile market environments? First, carefully consider what your long-term goals should be. Second, work with your financial planner to select options that fit your time frame, risk tolerance, and return profile.

Never speculate, invest for the short term, or invest in fads. Stay focused and patient. If you do not understand the investment, do not invest in it. Do not be a panic buyer or seller.

Please call if you would like assistance in determining your goals and asset allocation.

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.

News and Announcements

From the Thurman Household

My son, Levi, is busy with work. He still loves where he works and feels that he's making a positive difference. He is also really getting into Jiu Jitsu. He goes to class to "roll." I'm trying to learn the lingo so I can converse with him. Side guard, full guard, arm bar, triangle, Gracie. It's a whole new language.

By the time you receive this newsletter, I should have my next book out, ***The Worry-Free Retirement Guide to Finding a Trustworthy Financial Advisor***. It's taken about as long to decide on the title and book cover as it did writing the book. My book after that, ***101 Tax Strategies for Those Over 55*** (title subject to change, numerous times). The rough draft has been completed and is at the editors.

Our firm has just crossed over ¾ billion dollars of assets under management. This growth is due, to a large degree, from client referrals. So, thanks for the referrals!

Pati hasn't been doing much. Just a 15 mile hike up Pike's Peak, 70 mile bike rides, you know…normal stuff.

Have a great month!

Randy Thurman, CFP®, CPA/PFS

From the Flinton Household

"The greatest gifts you can give your children are the roots of responsibility and the wings of independence."

~ Denis Waitley

Well, another school year has begun and our daughters Samantha and Emerson are very excited for 3rd and 1st grade. This school year is sure to bring about new challenges and opportunities, and we are looking forward to all the new to come. Both girls are still staying involved with athletics and activities, however one big change did occur that we are eagerly anticipating. Samantha decided she wanted to take a break from soccer, and both girls have since jumped head first into golf; I am trying my best to temper my excitement! Ever since high school I've had a love for golf, primarily for the peacefulness and tranquility, and spending cool autumn mornings walking the course. I now only play a couple times each year, however with this newfound interest by Samantha and Emerson, not only might I get a few more rounds in, but I may have found my ideal golfing group.

Both girls have also begun playing the piano, and Courtney and I absolutely love to hear the girls in their "jam sessions" playing songs they've learned, and improvising in their own special ways. I often say that you are only as happy as your least happy child, and right now mom and dad are feeling very thankful and grateful for this time and season of life.

Wishing you a wonderful month,

Andrew Flinton, CFP®

From the Rudy Household

We are off to a great start this school year. It's hard to believe, but we have a senior, a sophomore, and a seventh grader. My wife, Amy, calls this the "Year of the S."

Kayla is looking forward to her final year of high school. She is the Editor in Chief for the yearbook. She has also completed the college application process. She narrowed her decision down to regional state schools and applied to UT, A&M, and OU. With Sooner parents, things may get interesting at college decision time.

Megan joined her sister on the yearbook staff. Moving to the newly opened high school last year, they are looking forward to working together to create the schools 2nd yearbook and further establishing the yearbook program. Megan also just got her learner's permit.

Driver's Ed is not taught in school, as it was when I was in high school. We're teaching her ourselves through the aid of an online course. She's quite a good driver in empty parking lots and neighborhoods with little traffic.

After a singing part and a few lines in last year's school play, Tatum caught the acting bug and is looking forward to the middle school theater production this year. She is also planning on trying out for the middle school basketball team and running track.

We're so proud of our girls and look forward to all the excitement this year should bring.

Chad Rudy, CFP®