On Course Financial Planning

Facing the Future with Optimism and Courage

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Vectors

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Sheltering in Place Musings

We are still locked up at home here in the People's Republic of Washington, so I've had plenty of time while sheltering in place to muse about investing and the economy.

Over time, stocks have gone up more than they have gone down. If this were not so, no-one would invest in stocks. Yet during the past 18 months we have experienced a stock market roller coaster that has rattled even the most even-keeled investor. From the fall of 2018 through the first week of June, the S&P 500 Index dropped 20%, gained 30%, dropped 35% and then gained 43%. Historically, investors who have been able to stand firm during stock market declines have been handsomely rewarded, while investors who sold in panic suffered permanent losses. The reason it is so important to maintain your composure during market declines is that the best days of stock market performance often come within a week or two of the worst days – during times of extreme market volatility. For example, from February 19th to March 23rd the S&P 500 fell 34%. Yet to everyone's surprise, the S&P 500 rose 9.4% on March 24th and from March 24th through June 3rd, the index had the best 50-day period of performance in its history – a gain of 39.6%.

March's 12.4% decline in the S&P 500 Index was the 19th worst month for the index since 1926 – a span of 1,131 months. As one might expect, this led to a stampede of investors' money out of stocks and into bonds and cash. To the dismay of those who panicked, the S&P 500 Index rose 12.9% in April - the 13th best monthly return since 1926. Many investors, faced with such uncertainty and volatility, scour the financial media for predictions, seeking insight into what to do next. But forecasts are useless. What they really need is a comprehensive financial plan that will help them withstand the stock market's inevitable gyrations.

In recent years, proponents of active management have insisted that their ongoing inability to outperform index funds was because index funds were benefiting from an ever-rising stock market. They contended that active funds would prove their value in the next bear market because unlike index funds, which must remain fully invested, active managers can deftly shift to cash or defensive securities to protect investors on the downside. We have just experienced a nasty bear market in which the S&P 500 fell 34% in a span of 33 days in February and March. March was the most volatile month on record for domestic stocks, as measured by the VIX index, which provides a measure of market risk and the fear level of stock investors. Equity prices swung as much as 5% in a day triggering stock exchange "circuit breakers" that paused trading in U.S. markets several times. This latest bear market presented the perfect opportunity for active fund managers to shine. So, how did they do?

As it turned out, only 34% were able to deliver total returns that beat their benchmark index in March and only 43% beat their benchmark index during the first quarter of 2020, according to S&P calculations. The data from European markets is similar. According to S&P Global, *"The majority of Europe equity fund managers were unable to beat the benchmark in either March or Q1 2020 as a whole, with 66% and 57% underperforming the benchmark, respectively."* This is similar to what occurred in 2008, the worst year for stocks during the financial crisis. The S&P 1500 total market index declined 37% in 2008. Yet it outperformed 64% of all actively managed domestic stock funds. The belief that bear markets favor active management is a myth that is unsubstantiated by the facts.

Each year it becomes more difficult to outperform the stock market because of what is known as the "paradox of skill". There are more intelligent, profit seeking, motivated fund managers today than ever before. It is estimated that more than 90% of trades in the stock market are done by professional money managers. The consensus opinion of these hard-working, talented people is reflected in current stock prices that are the end result of all their buying and selling. Their ongoing trading in response to new information efficiently adjusts prices. The costs of research and trading are borne by their investors. Contrary to popular opinion, index funds are not "mindless". Instead, they take a "free ride" on the back of active managers and their investors, accepting current stock prices as the best estimate of fair value. It might be the ultimate irony that it has never been easier to find a skilled fund manager, yet it has never been more difficult to find a manager astute and nimble enough to outsmart the consensus pricing of the market on an ongoing basis.

The current economic crisis has some counterintuitive characteristics. Stocks rebounded quickly despite the worst economic data of our lifetime. So, now the question is – "Why did the S&P 500 Index rise 43% from March 23rd to June 5th to a level just 6% below its all-time high and down just 2% year to date?" Certainly, one reason is that interest rates have fallen so low that bonds and cash investments are unappealing alternatives for investors. The response by the Federal Reserve and the federal government's fiscal stimulus have lent support to stocks. Investors are also keeping close tabs on state re-openings, which will reemploy furloughed workers, help stabilize the economy, and set the stage for a possible economic rebound later in the summer. Talk of vaccines has also helped. If we look at "high-frequency economic data" (daily or weekly reports), economic fundamentals are on the mend. The growth rate of new cases and deaths from Covid-19 is decelerating just about everywhere in the world. Daily gasoline usage has rebounded, hotel occupancy and weekly box office receipts are also trending upward. TSA passenger counts in the first week in June are three times the number reported just two months ago. On June 5th, the real estate broker, Redfin, reported that home buying demand is nearly 22% higher than it was before the pandemic and a lack of supply is fueling bidding wars. The median listing price is up 7% compared to this time last year. There was unexpected good news in the May employment report - nonfarm payrolls rose 2.5 million, easily beating the consensus expected decline of 7.5 million. The private sector added 3.1 million jobs - a testament to how quickly businesses have been able to adapt to the unprecedented shutdown of the US economy. It is no longer a question of when things will start to improve, but how fast they will improve. There is a long recovery road ahead, but the recovery has started, and the stock market appears to be pricing in a substantial recovery.

It's not the job of your financial advisor to make you richer than you can imagine; just richer than you would be on your own. The goal of comprehensive financial planning is not to maximize your short-term rate of return, it's to minimize your long-term financial regrets. Once you have created a portfolio appropriate for your financial goals, time horizon and risk tolerance, the best way to maximize its long-term return is to avoid portfolio tinkering during times of market volatility. The last thing that long-term, goal-focused investors should do when their friends, neighbors and co-workers are selling in panic is to join the crowd. Getting out, locking in losses, and waiting on the sidelines until things "settle down" isn't a strategy, it's market timing - a recipe for disaster. In addition, if you flee the stock market, you must then decide when to return. In most cases the decision to reinvest comes after a rebound has begun, resulting in missed opportunity. Exiting the market and then watching a subsequent rebound in stock prices can be unnerving. In this case, the stress of being in the market is replaced by the stress of being out of the market. The stock market goes to extremes in the short term more often than we'd like, which is the reason why wise investors make portfolio changes only when their goals or financial circumstances change, not in response to the market's daily, weekly or monthly gyrations.

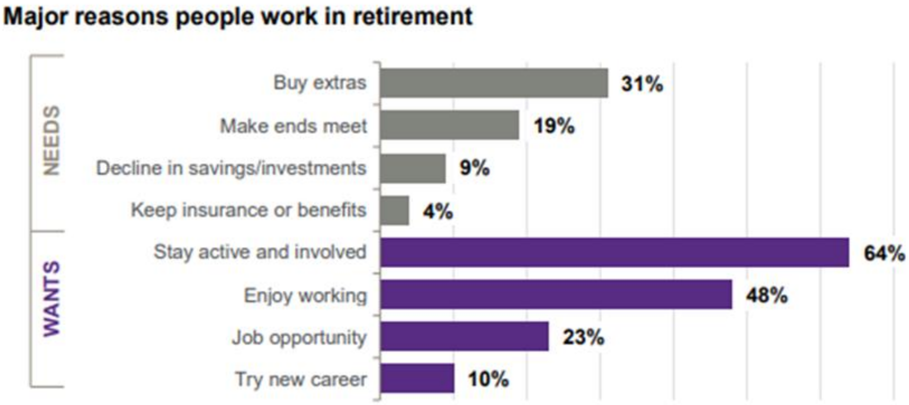
For many buy-and-hold stock fund investors stock dividends are an important, yet often unnoticed, wealth creator. For example, today the S&P 500 has a dividend yield of just under 2%, a rate that has been steady for the past decade. An investment of $1,000 in and S&P 500 Index fund, with 2% dividends reinvested, would be worth $1,219 ten years from now – even if the index has no gain over that time. Today, with the 10-year treasury yielding 0.9%, investors should not underestimate the value that reinvested stock fund dividends provide in the long-term growth of their portfolio. But be wary of financial advisors who promote high dividend paying stocks during times of low fixed income yields. Dividend paying stocks are never appropriate substitutes for high quality bonds in your portfolio.

There is no "optimal" portfolio allocation that will maximize long-term return because the relative performance of various asset classes is always changing. Yesterday's optimal portfolio is unlikely to be the optimal portfolio of the future.

Pessimism is intellectually seductive, and pessimists usually sound smarter than optimists, especially when their gloom dovetails with our own worries. Negative events are given more news coverage than positive events and it's easy to be influenced by media doomsayers who have perfected the ability to make the unpleasant sound catastrophic. Their unnerving screeds are often followed by commercials for gold coins. By emphasizing short-term events and the crisis du jour, the financial media misleads stressed investors into making short-sighted, counterproductive portfolio changes.

Sometimes, like these days, it seems like it takes all our energy to deal with the difficulties of life. No one can absorb all the grief and misery in the world – the best reason to minimize your immersion in the daily news. You'll have to admit that 90% of everything you heard in the news today has absolutely no impact on you or your loved ones but the same can't be said for its influence on your emotions, outlook on life and general feeling of well-being. In the real world, life generally fluctuates around a long-term average of what most of us would call "pretty good". It is a mistake to allow today's news to keep you from meditating on, and being thankful for, the good things happening in your life.

It is common for investors to lower their stock allocation upon retirement. After all, once you are no longer working, a lack of income makes it difficult to wait out a bear market. But a retiree's biggest risk is not stock market volatility, it's the loss of purchasing power due to inflation. Even 2% inflation will cut purchasing power almost 50% in a 30-year retirement. Retirees must balance their need to have financial peace of mind in the short-term with their need to maintain purchasing power via portfolio growth over the long-term. Therefore, most retirees need an appropriate allocation to stocks. "How much of my portfolio should be invested in stocks?" is a difficult question for most people to answer. The right answer for you is unique to your circumstances. It depends on your level of assets relative to your spending, your risk tolerance, and your ultimate goals for your portfolio, among other factors. In other words, there's no one-size-fits-all answer. Few people know how to calculate the answer to this question, which is why having a financial plan that addresses the topic of retirement income planning is so important.



The percentage of people 65 and older receiving income from pensions rose until the early 1990s, peaking at 38% in 1992. Today, more and more retirees are seeking to supplement their retirement finances with earned income. The most common reasons to work in retirement are shown in this chart from the *JP Morgan Guide to Retirement*.

Just Because I'm Paranoid....

It doesn't mean that the tax man isn't coming after us. A growing number of talking heads are predicting that tax rates will likely rise in the future as massive government stimulus programs swell the federal debt. It is inevitable that Congress will be looking for new sources of revenue in the years ahead. Here are four changes to the current tax law that would not surprise me -

The end of "back-door" Roth IRAs. High income earners (AGI greater than $139,000 for individuals and $206,000 for married couples) are phased out of Roth IRA contributions. However, they can take advantage of a "back door" Roth IRA by making a non-deductible contribution to their traditional IRA and immediately converting it to a Roth IRA. If they do not have other funds in the traditional IRA, no tax will be due on the conversion. This strategy bypasses the income limitations for Roth IRA contributions. Investors who can take advantage of a back-door Roth IRA should do so while they still can.

Require RMDs from Roth IRAs. Currently, Roth IRAs are not subject to Required Minimum Distributions (RMD) and it will not surprise me if Congress makes Roth IRAs subject to RMDs. These RMDs would be tax-free distributions, so what's the problem? Tax-free interest from municipal bonds is included when calculating how much of a retiree's Social Security benefit will be subject to federal income tax. Tax-free interest is also included in the Modified Adjusted Gross Income (MAGI) calculation to determine if a Medicare recipient must pay higher than standard Medicare premiums – called the IRMAA surcharge. IRMAA surcharges affect about 7% of Medicare-eligible taxpayers and the surcharges increase as MAGI increases. Including tax-free Roth IRA RMDs in these calculations would not surprise me in the least.

Limiting the tax deductibility of 401(k) contributions for high income earners. Under current law, salary deferrals are fully tax deductible at the taxpayer's marginal tax rate. A recent proposal, using pre-2018 tax rates, limited the deductions for higher earners by restricting the deduction to no more than 28% of their salary deferral even if the taxpayer is in a higher marginal tax bracket.

Cap the size of tax-favored retirement plans. A proposal that has made the rounds in recent years would prohibit contributions to IRAs, 401(k)s and similar retirement plans once the account reached a certain size. Further growth through investment earnings and gains would be permitted. The proposal did not require savers who already have more than the limit in their accounts to withdraw the excess but that's no guarantee that mandatory withdrawals wouldn't be part of a future change in the tax code.

Much like the stock market, future tax rates are unpredictable. Making investment decisions today based on a forecast of what the tax code will look like in the future is an unwise, speculative endeavor. Given the current high unemployment and weak economy, it is likely Congress will hesitate to increase taxes in the near future, especially since there seems to be an unlimited global demand for US Treasury debt. Investors must remain vigilant whenever Congress is in session. The tax code is written in pencil and Congress has the country's largest eraser.