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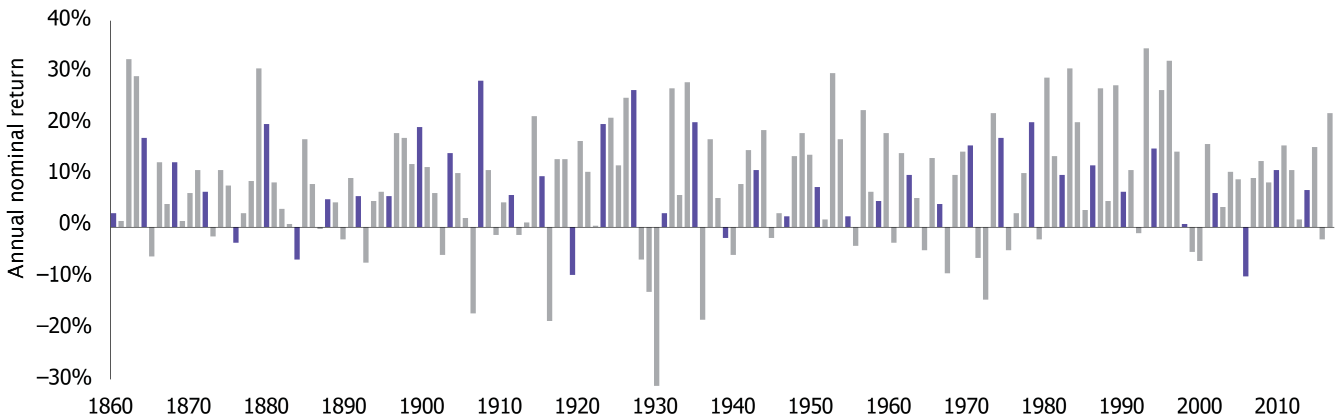
The Election!!!

The run-up to the presidential election is sure to bring a dose of anxiety to even the most stout-hearted investor. Hyper partisan Republicans and Democrats insist (as always) that a victory for their opponent will bring disaster to the economy and stock market and usher in the end of America as we know it. High on the list of "Ten Ways to Mess Up Your Portfolio" is to allow your political beliefs to influence your investing decisions. As Warren Buffett has said: *"If you mix politics with your investment decisions, you're making a big mistake."* There are so many random variables that effect stock prices that it is foolish to pick one variable (like who wins an election) and then leap to sweeping conclusions. This chart from Vanguard provides some needed perspective. The blue bars represent the return of a typical 60% stock/40% bond portfolio during presidential election years while the gray bars show the returns in non-presidential election years. The average return was 8.9% during election years and 8.1% in non-election years.



Considering what has been going on in the last few years, we can all appreciate the concerns about America's future. Many people consider a socialist future as inevitable. They believe that feeding off the public trough is a habit that our country cannot kick. Americans have a proclivity to obsess over worst case scenarios, reinforced by the ongoing negativity of the 24/7 media. But, by definition, worst case scenarios do not represent what is likely to happen. A rising socialist trend may or may not be in our future. In the meantime, we would do well to rid ourselves of the anti-historical belief that any current trend (political or economic) will continue in a straight line to the horizon and beyond. In behavioral economics this error is called recency bias – the belief that the recent past represents the "new normal", the new permanent reality. To see the folly of such thinking, we only need to look back a few years when the conventional wisdom asserted that home prices could never go down or that companies with .com in their name didn't need earnings to be valuable.

Vanguard noted in its analysis: "*Election years can be fraught with uncertainty as developments surrounding the candidates, their platforms, and their predicted effects on the economy and markets dominate the news. But should you let this stream of political information influence how you manage your investment portfolio? A lengthy history of empirical research suggests not."*

Presidential election years present financial advisors and their clients with a multitude of "what if" questions. None can be answered in advance. Vanguard's conclusion is that presidential elections are significant events, but not necessarily for your portfolio. Presidential elections have rarely proven to be inflection points for economic or market cycles. Presidents can make things marginally better or worse when it comes to the economy and stock market. They usually claim too much credit when things go right and receive too much blame when things go wrong. The economy is extremely complex and the relationship between markets and politicians is even more complicated. The election's outcome is just one variable among a multitude of economic and geopolitical factors that will drive the stock market and economy in the years ahead. Attempting to outguess the market's response to the election is a leap off the high board into the empty pool of market timing. In order to outsmart the election's outcome, you need to know not only who will win the presidency and both houses of Congress but also discern which economic and tax proposals will become law. You will also have to properly assess their economic impact and know whether these eventualities are already priced into financial assets.

If you feel the need to change your portfolio allocation in advance of the election, this might indicate that your portfolio allocation and risk tolerance are misaligned. If you are a do-it-yourself investor, this might indicate that you need the help and guidance of a capable financial advisor. If your financial advisor recommends pre-election portfolio changes, this might indicate that you need a real financial advisor. Your portfolio's equity allocation should be appropriate for your financial risk tolerance; one that can be held for the long-term. It should not be influenced by who lives in the White House or the alternating spells of optimism and pessimism that float through the financial markets. Successful investors focus on what they can control and use the strategy outlined in their financial plan to direct their investment decisions. By maintaining perspective, discipline, optimism, and a long-term outlook, they continue progressing toward their financial goals, despite the short-term uncertainty that events such as elections can create.

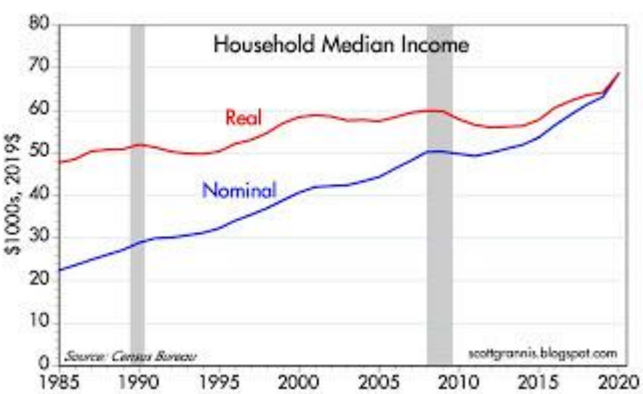
We are a practical and sober nation of 330 million citizens. Never in our history have we placed more confidence in our political class than in ourselves. Post-election changes in policies, tax rates, interest rates, etc. are topics that will need to be addressed during subsequent annual reviews with your financial advisor. They may lead to some minor changes in your financial plan to continue on course to achieving your long-term goals. A growing economy fueled by innovation and entrepreneurship has been the primary driver of stocks over many decades. No matter who gets elected, America's best companies will continue to use their ingenuity, innovation, and expertise to thrive. If our next president and Congress can ensure that the spirit of innovation and entrepreneurism that has defined America in the past will continue, our economy and quality-of-life will maintain their preeminent positions in the world.

In the News

A claim that we often hear these days is that "the middle-class is disappearing". This is true, but not the way most people think. According to data from the Census Bureau report "Income and Poverty in the United States: 2019", in 1967, only 10.6% of US households earned $100,000 or more (in 2019 dollars). In 1967, 53.5% of US households were considered middle income - earning $35,000 to $100,000 (in 2019 dollars) and the share of low-income households earning $35,000 or less (in 2019 dollars) was 35.9%.

In 2019, more than one in three US households (34.1%) were in the high-income category, a new record high. The share of middle-income households has decreased from 53.5% in 1967 to 40.5% in 2019 and the percentage of households in the low-income group has decreased from 35.9% in 1967 to only 25.4% last year, a new record low.

So, the truth is that if the middle-class is disappearing, it's because households in the US are gradually moving up to higher-income groups, and not down into lower-income groups as many in the mainstream media would have you believe.



This is a chart of the Census Bureau's calculation of Median Household Income for 2019. It shows the 6.8% increase in real (inflation adjusted) US median (half make more, half make less) household income last year (to $68,703) - the largest annual increase in median household income since the Census Bureau started reporting this data in 1967. Additionally, US household net worth set a record of $119 trillion in the second quarter, an increase of 6.8% from the year's first quarter, thanks to the stock market recovery and federal relief measures. Household net worth is the difference between assets (such as bank accounts, stock investments and real estate) and liabilities (such as mortgage balances and consumer debt).

The jobs report released on Oct. 2^{d} revealed that private sector (non-government) jobs increased by 887,000 in September. Private sector jobs have recovered about 54% of the losses that occurred due to the Covid shutdown. US and Eurozone manufacturing indices have rebounded from their Covid lows, and are now consistent with relative healthy economic growth conditions.

The S&P 500 gained 8.5% in this year's third quarter. When added to the gains in the second quarter, it yielded the best two-quarter performance since 2009. Through the first week of October in this very volatile year, there have been 90 days in which the S&P 500 rose or fell 1% or more - 51 to the upside and 39 to the downside for those keeping score.

October 19th marks the 33rd anniversary of the largest one-day stock market decline in history - 22%. At the close, the Dow Jones Industrial Average stood at 1,738. I remember it only vaguely. I'm sure the talking heads were predicting the imminent end of the world. But the world didn't end, Thanksgiving wasn't canceled, and Santa arrived on time. The

Apocalypse du jour will always be with us – elections, budget deficits, tariffs, trade deficits, inflation, riots, September 11th, or Covid-19. Problems come and then, somehow, they go, and the world does not end. And this is how it will always be, as long as we remain a nation of problem solvers who regularly turn imminent disaster into events barely remembered. As I write this, the Dow Jones Industrial Average stands at just above 27,000 – an annualized average rate of return, excluding dividends, of 8.7% since that demoralizing day. It is impossible to be a successful investor if you are afraid of the future. Facing the future with optimism and courage. It's as important today as it was 33 years ago.

Quiz Time

How many retirees and soon-to-be retirees have the financial savvy to manage their finances well enough to avoid running out of money in retirement? My answer has always been "few, if any" and there's ongoing evidence to support my belief.

The American College of Financial Services created the Financial Income Literacy Quiz which contains 38 multiple-choice questions covering financial subjects that retirees need to understand if they are to successfully manage their finances. Earlier this year, the quiz was given to 1,500 people between the ages of 50 and 75 who have between $100,000 and $1.5 million in financial assets. Here's a link to the quiz. Be forewarned – unlike most financial literacy quizzes I've seen, this one requires you to know a thing or two. You must score above 60% (23 correct out of 38) to pass the quiz.

How did you do? The average score for the respondents was 42%. Only 19% passed the quiz, even though about one out of three consider themselves highly knowledgeable about retirement income planning. The results roughly mirror those of similar surveys in 2014 and 2017. The American College of Financial Services noted in its summary – "*Americans have a particularly low knowledge about preserving assets and sustaining income in retirement.*" Some of the areas of concern noted in the report were –

- Only 28% know that actively managed mutual funds have higher fees than exchange traded index funds.
- More than half underestimated the life expectancy of a 65-year-old man, thereby underestimating how long retirement assets must last.
- More than one third answered "I don't know" to the question: *What percentage of a portfolio should be invested in stocks if it must finance a 30-year retirement?*
- Only one in three understand the 4% rule. This rule of thumb states that to finance a 30-year retirement, you should limit your first annual withdrawal to 4% of your portfolio and then annually adjust it upward for inflation. This rule assumes a portfolio allocation to stocks of 40% - 60%. Thus, $4,000 is the most that can be "safely" withdrawn in year one of retirement from a $100,000 portfolio. The results suggest that two thirds of those surveyed do not understand prudent limits to annual portfolio withdrawals.
- Only one in four understand that the price of a bond will fall if interest rates rise and only one in five understand that higher bond yields are associated with higher default risk.
- Half did not know that the best way to protect against inflation has been to own a diversified portfolio of stocks.
- Only 29% know that employees will not lose their 401(k) if their employer files for bankruptcy.

In retirement, the emphasis shifts away from accumulation and focuses on the more difficult topic of distribution management. Think of it this way. During your working years, you are filling up a bathtub. For those who started filling their tub late or who must make up for investment mistakes, catch-up provisions allow additional contributions to IRAs and 401(k)s for those aged 50 or older. When you retire, no such "refilling" options are available. You get in the tub, turn off the spout and open the drain. The popular media provides almost no information about distribution management and few retirees have the knowledge and temperament to competently manage the distribution phase. We tend to swing between over-optimism when things are going well and over-pessimism when things are not going well. Since fear is more powerful than smarts, doing the wrong thing at the worst time is almost guaranteed. Even though past investment performance is no guarantee of future returns, past investor behavior is indicative of future investor behavior. Once retired, you have just one shot to get it right. You cannot let your tub run out of water.

Retirement planning is not about exact numbers. It requires making broad conservative estimates about the unknowable future. Therefore, we must always err on the side of excessive savings and moderate return expectations. The first line of defense is to admit that the future is a mystery and forgo all attempts to predict it. Accumulating retirement assets and then managing retirement income requires specialized knowledge that goes beyond the basic financial principles that can be learned from reading a few books or scouring the financial media. Most Americans are unaware of the large gap that exists between what they know and what they need to know to successfully manage their retirement assets. For many of them, this will not end well.