On Course Financial Planning
Facing the Future with Optimism and Courage
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Thinking About Risk

With the stock market's wild ride in the first half of 2020, now might be a good time to revisit some aspects of portfolio risk management. When Wall Street firms, economists and media talking heads mention investment risk, they usually equate it to volatility. If two investments have the same long-term rate of return, the one that has the greater year-to-year variation in returns is considered the riskier of the two. But volatility is not how most investors weigh risk. Rising stock prices make us happy. When most investors think of risk, it's falling stock prices and permanent capital loss that they fear.

Risk tolerance. One aspect of risk management that concerns financial advisors is a client's risk tolerance. In other words, how much can your portfolio decline before you say, "I can't take it anymore!"? Everyone's risk tolerance is high when the stock market is rising. Many investors that I have talked with say that they would feel uncomfortable with a portfolio decline of 20% or more. Since 1980, the average intrayear decline in the S&P 500 Index has been 13.8%, according to JP Morgan. So, there's not a big buffer here. An easy way to moderate portfolio volatility is having an appropriate allocation to US Treasury securities. They won't make you rich, but they'll increase your sleep-at-night factor.

Risk capacity. Closely related to risk tolerance is risk capacity. Soon-to-be retirees have little time and future income to recoup portfolio losses after a stock market decline. So, older investors are said to have a lower risk capacity than younger investors, who have time and future income to recoup losses.

Value at risk. A little mentioned aspect of risk management is called value at risk. A young worker with $10,000 in a 401(k) has little value at risk if stocks decline 40%. But someone entering retirement with $1 million invested in stocks has a great amount of value at risk. Value at risk is a vital concern for every retiree and it is one reason why an appropriate allocation to high quality fixed income assets is so important.

Lack of diversification. Your portfolio should contain funds that, at any given time, are disappointing you. While some have increased in value year-to-date, others will barely be in positive territory or even showing a loss. This is a good thing. In investment speak we say that your portfolio should contain assets that are not correlated; assets that do not go up and down together. For example, on days when stock funds are in the red, short-term government bond funds are usually in the green. It's natural to want all the funds in your portfolio to go up together. But this requires owning funds that contain similar, correlated assets. Unfortunately, correlated assets also go down together. A portfolio containing correlated assets will be more volatile than a portfolio consisting of non-correlated assets.

Media risk. This is a relatively new hazard for investors, the result of 24/7 news. Every day, the financial media gives investors something to worry about. The daily news is a cacophony of distracting shouts, a litany of isolated events with no long-term importance that raise blood pressure and cause investors to fixate on the short-term. Short-term stock market volatility is often greater than many investors can endure, causing them to change their financial priority from winning to not losing. The consequences of poor investment decisions made in response to the latest financial news (or its advertisements) will be felt long after the news events have been forgotten. I can remember, not so long ago, when today's news was reported in tomorrow's newspaper. For those who couldn't wait until tomorrow, a 30-minute TV news program at dinner time or just before bed summarized the day's events. We were not unaware of what was happening and nothing of historical significance passed by unnoticed. Anything that happens in the news today that doesn't make it into tomorrow's history books isn't worth your attention. Decrease your intake of the relentless negativity of the daily news, whether fake or not, and see how much better you feel.

Individual stock risk. Index funds give investors the opportunity to own the total stock market at almost no cost. Therefore, the only reason to own individual stocks is to attempt to outperform the market. If your favorite stock has been mispriced by the market, it might outperform. But don't count on it. Current prices in global stock markets represent the combined views of millions of participants. All public information about companies is already reflected in prices. Owning individual stocks adds additional, unnecessary risk to your portfolio and can hamper portfolio diversification if insufficient funds remain to invest in other important asset classes. In my experience, portfolios of self-serve investors contain shares of a few well-known, large national companies whose stocks have outperformed in the recent past. If your financial advisor recommends individual stocks, you are adding another type of risk to your portfolio

– **financial advisor risk**. Your financial advisor has no ability to pick stocks that will outperform the market. Trust me, I know these people. Advisors who recommend individual stocks add stress and anxiety to their professional lives and more risk to their clients' portfolios. Historically, most investors have been able to achieve their financial goals by receiving market equaling returns during their working years. Instead of owning individual stocks, it is much wiser to invest in index funds that own hundreds or thousands of companies. Not every company will survive, but the failure of any one company will have no impact on your portfolio.

Sequence risk. Your portfolio's performance in the first years of retirement will play a big factor in whether you will be able to maintain your desired lifestyle. Let's consider a retiree who withdraws $10,000 from a $100,000 portfolio each January 1st. If the sequence of annual returns is +5%, +10% and -20%, the ending value after three years will be $66,360. But if the sequence of returns is -20%, +10% and +5% the ending value will be $61,110. Periodic portfolio withdrawals during a prolonged stock market decline require that more stock fund shares be sold to yield the same dollar value. Sequence risk -- the possibility that the famine will precede the feast -- is a real threat to retirement security. Will you be lucky to retire just before a bull market or unlucky to retire just before a bear market? It would be foolish to ignore this risk and just hope for the best. My solution to sequence risk is known as a "buckets" strategy. Upon retirement, allocate an adequate portion of your portfolio to high quality fixed income funds that will be drawn down to fill the gap between expenses and income. I like having enough to last 10 to 15 years. The remaining assets in your portfolio can be invested in stock funds that are left alone to grow with dividends reinvested. This doesn't eliminate sequence risk but it’s the best strategy that I know of to deal with the problem. It attaches assets to expenses. Near-term expenses are paid with money that sits in high quality fixed income assets. Expenses a decade or more in the future will be purchased with assets that are invested in stocks today.

In the News

On February 19, 2020, the S&P 500 closed at its all-time high - 3,386. Just 23 trading days later, on March 23, it closed at 2,237, a drop of 34% — the sharpest drawdown in history over such a short time. In this year's first quarter, the S&P 500 was down 19.6% - the ninth worst quarterly performance since 1926. Then, to everyone's astonishment, from March 24 through June 3, the index had the best 50-day period of performance in its history – a gain of 39.6%. In this year's second quarter, the S&P 500 rose 20.5% - the ninth best quarterly performance since 1926 and its best quarterly percentage gain since 1998, according to the *Wall Street Journal*. Put the two quarters together and the index is down 2.7% for the first half of the year. This has been a remarkable, unexpected rally after the Covid–19 pandemic brought business around the world to a virtual standstill. Those of us who stayed invested during the unpleasantries during this year's first quarter were able to enjoy our hard-earned second quarter reward with a sense of relief. Those who fled to cash are now burdened with the self-imposed torment of trying to decide when to reenter the stock market. According to J.P.Morgan, the average interest rate paid by money market funds has been less than inflation in each of the past 12 years. Few investors can remain invested in cash and bonds and meet their long-term financial goals.

One thing for sure – no forecaster saw this coming as we entered 2020. No matter, these same forecasters are now regaling us with their midyear forecasts for the second half of 2020 and many financial advisors are sending "midyear updates" to clients. These updates are used to give clients the impression that the advisor has his fingers on the pulse of the stock market and the economy. In truth, most contain borrowed ideas and text written by someone else. Forecasts create the mirage that the future is knowable to a few, remarkably prescient individuals. Some things are easy to predict, (good pitching beats good hitting, defense wins championships, you drive for show and putt for dough), but most are not. My midyear outlook is short and sweet – nobody knows what will happen in the stock market or the economy between now and New Year's Day 2021. Anyone suggesting otherwise is a fool and you are a bigger fool if you listen to them. Smart, articulate experts offering eloquent, conflicting predictions appear each day in the financial media. Most of their predictions are nothing more than extrapolations of the recent past – a poor foundation for their "educated guesses". (To me, the phrase "educated guess" is an oxymoron.) Many Wall Street reputations have been made by making just one noteworthy prediction. As the economist Alfred Cowles observed almost a century ago, people “*want to believe that somebody really knows*.” But as Cowles knew, there are no prescient forecasters. But as long as we continue to ask the so-called experts about the unknowable future, their braying voices will continue to distract and mislead us. How refreshing it would be if, lacking an audience, these prophets fell silent.

If your financial goals have not changed since New Year's Day, the events of the first six months of this year provide no compelling reason to change your portfolio allocation. Successful investors are goal focused and planning driven. During times of market volatility, their financial plan gives them the basis on which to act, even when things don't seem to be going well. Acting on a prudent plan that is based on reasonable expectations is inherently forward-looking. In the absence of a plan, investors can only react. Reacting is inevitably backward looking – trying to find profit in (or protection from) things that have already happened – at which point it's too late. A never-ending purgatory of woulda, coulda, shoulda. Been there, done that, got the t-shirt.

Just as we have seen this year, the historical record reveals that the stock market has most of its significant gains in a small number of days, often for no apparent reason. Buy-and-hold investors are certain to be invested during both the worst and the best days. I can live with this because, historically, the good years have outnumbered the bad years by a wide margin. Buy, hold and rebalance investing requires investors to withstand painful, temporary losses and the ability to do nothing most of the time. This is easier said than done and explains why active management maintains its popularity despite its poor track record. People want to believe that with enough number crunching, research, and chart gazing, uncertainty can be vanquished, and volatility can be sidestepped. Alas, it is not so. Beware of anyone trying to convince you that you can avoid the stock market's unpleasant temporary declines by using some type of market timing strategy. Nothing has turned more investors into unwitting speculators than the idiotic idea of market timing.

Life is full of uncertainty and many people feel that we are living in a day when the future is more uncertain that ever. Recently, Federal Reserve Chairman Jerome Powell said, "*The path forward for the economy is extraordinarily uncertain and will depend in large part on our success in containing the virus.*" Extraordinarily uncertain? That is a redundancy. When it comes to investing, the words "future" and "uncertainty" are synonymous. The future is always 100% uncertain - on full bright all the time, and despite the pretentions of some, there isn't any way to turn it off or dim it. In good times we ignore uncertainty. In volatile times we fixate on it. How bleak or rosy the future appears today is opinion, not fact. There will never be a time when uncertainty settles down. The only thing that is settled is history because we have yet to discover a way to go back and mess it up some more.

My Lazy Golfer portfolio consists of five Vanguard index funds-- allocated 40% to the Total Stock Market Index Fund (VTSMX), 20% to the Total International Stock Index Fund (VGTSX), 20% to the Inflation Protected Securities Fund (VIPSX), 10% to the Total Bond Market Index Fund (VBMFX) and 10% to the REIT Index Fund (VGSIX). It has an annual expense ratio of 0.17%. Rebalance the fund on your birthday and ignore Wall Street for the remaining 364 days of the year. For the 12 months ending June 30th the Lazy Golfer earned 3.9%, according to Morningstar, – not bad, considering. Its annualized average return over the past five years has been 6.4% and 8.7% for the last ten years. You'll save time, money and energy and can ignore all the beat-the-market nonsense by investing in low-cost index funds. Admittedly, many investors find this recommendation unsatisfying because, surely, someone must be smart enough to beat the market. Maybe so, but that person has yet to make an appearance.

It has been disheartening to read reports that day trading is making a comeback. Apparently, some "investors" are using their government stimulus money to day-trade stocks. Perhaps many of these new day traders are bored sports fans, who, with no sports to bet on, are now betting on stocks. Their entry into the online trading casino has been easier than ever with commission-free trades and instant online updates of stock market activity. Like their predecessors, these traders are making significant bets based on noise – the babble emanating from Wall Street every day. Will these sports-betters-turned-day-traders go away once sports come back? Time will tell. My guess is that like their forerunners, they'll run out of money before their favorite sports return. Human nature never changes. Speculation is as old as the hills and whatever bad ideas have been in favor in years past are sure to have their day in the sun again.

If the Covid-19 pandemic is the end of the world, you might as well ignore social distancing and masks and party like there's no tomorrow – because there is no tomorrow. There will be no need to be concerned with financial planning, tax planning, long-term care insurance, portfolio allocation, saving for college, budgeting, or estate planning. But if history is any guide, we'll manage to get through this latest mess and financial planning will be more important than ever. Don't be paralyzed into inaction because the future seems uncertain or scary. Shut off the TV, ignore the talking heads and get your financial house in order. Spend your time focusing on what is probable instead of what might be possible. That way if Armageddon once again goes missing in action, you won't be facing the future paralyzed and unprepared.

When it comes to money, your emotions are your worst enemy. The volatility that we have experienced in the first half of 2020 should remind us that successful investing isn't about outsmarting the capital markets, it's about making a plan, controlling your emotions and sticking with your plan come what may. The ultimate benefit of good financial planning is peace of mind. We tend to ignore the lessons of history despite an uncomfortable number of reminders. One lesson is that 20% - 30% declines in the stock market have been normal, recurring, and unpredictable occurrences. Get used to it. Investing should be boring most of the time and painful at irregular intervals. We don't know what the causes of future bear markets will be, when they will occur or how long they will last. A robust financial plan will account for the inevitability of bear markets. Forget about great new ideas. Here's a great old idea - slow and steady wins the race.