On Course Financial Planning

Facing the Future with Optimism and Courage

October 2022

Vectors

geo@oncoursefp.com

425-861-9997

Bear Markets Musings

We are suffering through the 13th bear market (defined as a time when the S&P 500 drops 20% or more) since the end of World War II. The causes and circumstances of each bear market differ enough so that the "This time it's different!" assertion always seems plausible. Fear and pessimism are common in all bear markets. If all bear markets were the same, they'd produce a lot less investor angst. The average post-WW II bear market has lasted a year but the last one, during Covid, lasted just one month. One bright note is that all bear markets have been temporary and were followed by new all-time highs in the stock market.

This bear market's first victims were those companies that were popular during the Covid excesses of 2020 – companies whose share price could be justified only if we'd be working and schooling from home forever. Repricing this short-term-focused silliness in a post-Covid world was to be expected and over the past 12 months some of the most favored stocks of 2020 have experienced large declines. But the bear market didn't stop there, and it has now hit the stocks of companies in all sectors of the economy.

If you are still in the accumulation phase of life and remain employed in this actual, or soon-to-be recession, you can take advantage of this bear market. Every 401(k) contribution buys more shares than it bought a year ago, creating a low-cost foundation for future gains. Retirees who own a balanced portfolio have benefitted from the outsized gains in their stock funds over the past decade, which more than made up for the non-existent yields of their bond funds. Today, retirees can lock in decent yields in the bond portion of their portfolio which will help portfolio growth going forward. The accumulator or retiree who is reinvesting stock fund dividends today is adding shares at bargain prices that will boost future portfolio growth.

Although bear markets are unpredictable, some things occur in every bear market. Prophets of doom will appear in the financial media proclaiming the imminent end of everything that we hold dear. Every stock market rally will be called a "sucker's rally" or a "dead cat bounce". Bloggers on social media (a technological development of questionable value that enables village idiots throughout the USA to find each other and discuss their inanities) will claim that the stock market is a rigged game. And the forecasting business will go into overdrive.

I have been expressing my disdain for forecasts for as long as I have been writing this newsletter. My scorn stems from the fact that forecasts create the idea that the future is knowable. This is folly. Yet many of us invest our hard-earned dollars based on forecasts made by people we have never met, whose credentials are unexamined, whose track record goes unmentioned and who you might not want to have as a neighbor.

Economic forecasting is a big business. There are thousands of economists in the United States who generate forecasts on a regular basis. Forecasters work at every level of government. The most famous and powerful are the chairman and governors of the Federal Reserve – whose track record of failed forecasts is legendary. The President has an economic forecasting team called the Council of Economic Advisors. Congress has its own independent economic advisors in the Congressional Budget Office. There are many private companies that sell economic forecasts, and many corporations have their own staff of economists. Financial institutions such as banks, mutual funds and brokerage firms provide forecasts for their clients. In fact, there are so many forecasts that there are people who publish consensus forecasts of economic forecasters. Let's don our skeptical glasses and take a closer look at this ongoing charade.

Today, all forecasters are trying to answer the big question, "Where are the economy, the stock market and interest rates headed?" America only needs one good forecaster, someone with an internet connection and a Twitter account. The fact that so many economists are still employed proves that America's Expert Forecaster has not yet appeared. Maybe this person will appear on the scene someday, but I'm not holding my breath.

Forecasting is difficult because hundreds of millions of consumers, all with their own personal motives, views and ideas make billions of economic decisions each day that determine the health and direction of our economy. Making a correct economic forecast requires knowing not only what will happen, but how consumers, investors and market participants will react to what happens. But our behavior is influenced by our emotions, which can never be modeled successfully. Thus, most forecasts are mere extrapolations of the recent past and therefore are unlikely to be correct often enough to be beneficial. Well-known market forecasters have been wrong time and time again. There is no professional danger in this because most forecasters make predictions that are close to the forecasts of other pundits. As long as you're no more wrong than the next guy, you're not likely to get canned.

I don't think that most forecasters are villains or charlatans. Most are bright, educated professionals who believe that their forecasts will help investors. But I agree with this quote by John Kenneth Galbraith- *"There are two kinds of forecasters: those who don't know, and those who don't know they don't know".*

Stop worrying about what's in store for the economy or the stock market. Nobody knows. The next time you hear a stock market or economic forecast, just add the words "or maybe not" at the end of it. The good news is that you can be a successful investor without listening to market forecasts. You don't need to predict, but you do need to plan. By investing in index funds you're not trying to guess which companies will succeed. You're investing in the ingenuity of corporate leaders to serve their customers and make their companies thrive, despite what's happening in the economy or in Washington, DC. My advice is to stop listening to forecasts, the future will be yesterday soon enough.

The third quarter of the year has come to an end. This year's dismal performance of stocks and bonds means that pundits as numerous as the falling leaves of autumn will come out of the woodwork to give us their opinion about what to do now. You're sure to hear variations on the following themes –

- **It's a stock picker's market.** In every bear market, proponents of active management insist that owning index funds is a losing strategy because a "stock picker's market" has arrived. They recommend buying active funds whose prescient managers can pick the winners and shun the losers. Wall Street promotes this reasonable sounding misconception, which ignores the historical performance of active funds. There is little merit to the notion that active funds are more capable of navigating market volatility than their passive counterparts. Morningstar studied the performance of nearly 3,500 active funds in 2020 and noted – *"In 2020, the coronavirus selloff and subsequent rebound tested the narrative that active funds are generally better able to navigate market volatility than their passive peers…there's little merit to this notion. Across all 20 categories we examined, just 49% of the nearly 3,500 active funds included in our analysis survived and outperformed their average passive counterpart."* Invest in index funds unless you have special insight into the market. Newsflash - you don't.
- **Buy and hold is dead.** Market timers bring out the "buy and hold is dead" claim in every bear market. It's easy to understand why market timing schemes gain popularity during bear markets. But beware. The recommended strategies usually involve financial products that are expensive, tax inefficient, and unlikely to perform as promised. All alternatives to a buy-and-hold strategy are variations of the sell-wait-and-guess strategy, which is unlikely to be more successful today than it has been in the past. Few market timers realize that the stock market's best days have been in the immediate aftermath of major declines. The rebound usually arrives suddenly, unannounced, and leaves the station before market timers can get aboard. Market timers enter into a Twilight Zone of short-term speculation using strategies that often rely on prophesy without the benefit of divine inspiration. It's an eerie world where greed, graphs, and infomercials are used to separate the unwary from their money. Studies of investor behavior reveal that the more actively you trade, the less you make. The longer the time horizon, the more likely it is that buy and hold will be the best strategy.
- **Use alternative investments.** Their promoters claim that these assets are non-correlated to stocks and bonds. Things like cryptocurrencies, NFTs, private equity, hedge funds, SPACs, non-traded REITs, and structured notes. Typically, the value of these assets cannot be determined from public sources and investors have to depend on the issuer's estimate of their value. If history is any guide, and it's the only guide we have, these estimates are likely to be more optimistic than realistic. In its recent study of alternative asset funds, Morningstar concluded that they sound nice in theory and look good in backtests, but most haven't performed as advertised.
- **Stocks to Buy Now**. "What to Buy Now" articles are a trap. They pretend to offer easy solutions in today's difficult investment environment. Simple, one-size-fits-all answers are likely to be wrong. They ignore your goals, time horizon and risk tolerance and shift your focus to short-term issues. Typically, they recommend individual stocks that are predicted to be outperformers in the current economic environment. But owning individual stocks brings individual company risk into a portfolio and lessens the likelihood of adequate portfolio diversification. "What to buy Now" articles promise what they cannot deliver - riskless investing through a knowledge of the future.
- **The 60/40 portfolio is dead**. For several years, pundits have declared the death of the classic, moderate allocation 60% stock/40% bond portfolio. The annualized return of the 60/40 portfolio (S&P 500/US Aggregate Bond Index) from 1928 through 2021 was 8.1%, according to Vanguard. This year's "perfect storm" of negative news has led to declines in both stocks and bonds which has called into question the diversification benefits of a balanced portfolio. Bonds are used to provide portfolio stability by offsetting stock volatility. This year, not so much, since rising interest rates have caused losses in both bonds and stocks. Consequently, the 60/40 portfolio is having one of its worst years since 1928.

Vanguard analyzed the real (inflation adjusted) returns of the 60/40 portfolio since 1928 -

Notes: Periods analyzed are rolling monthly periods from January 1928 through August 2022.

	1 Year	3 Years	5 Years	10 Years	20 Years
Probability stocks have positive real return	70%	78%	80%	87%	100%
Probability bonds have positive real return	65%	71%	72%	74%	76%
Probability 60/40 has positive real return	71%	80%	86%	90%	100%

Surprisingly, the 60/40 portfolio has had real positive returns more often than the 100% stock portfolio. This is because of the diversification benefits that bonds have provided during bear markets. Typically, stocks decline when the economy slows, which leads the Fed to lower interest rates which, in turn, causes bond prices to rise. Not so this year. Price stability is the foundation of a strong economy and long-lasting economic expansion. The Fed's aggressive rate increases to combat inflation have hurt both bonds and stocks.

Vanguard notes that since 1976, simultaneous declines in both stocks and bonds occurred once in every 250 rolling 12-month periods - call it once every 20 years. Thus, the declines in both stocks and bonds that we've experienced this year is rare but not unprecedented. Don't allow emotional responses to portfolio volatility distract you from your long-term financial objectives. Such statements as "the 60/40 portfolio is dead" focus on short term performance and create a disincentive for investors to keep focused on their long-term goals. Vanguard noted that "*market volatility means diversified portfolio returns will always remain uneven, comprising periods of higher or lower - and, yes, even negative returns.*"

Contrary to what most people believe, low prices create the expectation of higher future returns. Thus, today's higher bond yields and lower stock prices make the return outlook for a 60/40 portfolio more attractive than it was 12 months ago. This is why selling after a decline makes no sense if your goals, time horizon and risk tolerance haven't changed. Successful investing over the long-term requires perspective and discipline. Future economic travails lie ahead but the 60/40 portfolio is not dead by any stretch of the imagination. Those who proclaim otherwise are likely trying to sell you something.

- **You have to be tactical now to protect yourself**. Tactical asset allocation funds shift between asset classes in an attempt to benefit from short-term changes in market trends. Tactical asset allocation is market timing with a name that gives an aura of prescience to this debunked strategy. It also gives financial advisors the opportunity to appear to be "doing something" when client portfolios are declining. According to Morningstar, for the ten years ending August 31, 2021, the average annualized return of the tactical asset allocation funds in its database was 6.2% compared to 8.9% for funds that hold a fixed stock allocation between 50% and 70%. Tactical asset allocation funds have a high mortality rate - almost 50% according to Morningstar. Some of the performance shortfall can be attributed to the high, 1.5% average annual expense ratio charged by funds in this category. The poor historical performance of tactical asset allocation funds supports Yogi Berra's observation that *"Predictions are difficult, especially about the future."*. In its summary, Morningstar noted: *"Despite a few isolated success stories, the overwhelming body of evidence suggests that tactical asset allocation is detrimental to investors bottom lines. Instead, investors are far better served by funds that maintain more stable asset mixes, as well as by avoiding the temptation to make shorter-term shifts in their own portfolios."*

A year ago, few investors or professional forecasters saw inflation or a bear market on the horizon. Every generation of investors must deal with changing financial events while staying focused on their goals through good times and bad. Bear markets test our patience, and our emotions can easily overcome perspective and long-term thinking. Seeing your portfolio decline can upset your peace of mind. There's nothing unusual or abnormal about this, it's human nature. The big mistake is to act on your emotions. There is no guarantee that buying stocks when they are down will lead to better outcomes, but history tells us that expected returns are higher when prices are lower. Wise investors don't invest based on their fears about what might happen but rather on what's most likely to happen. This is an insight that few investors possess and one reason why so many investors underperform the market. The great advantage you have over professional money managers is the option to sit still, ignore the market's daily noise, and get on with your life, focusing your time and attention on dimensions of life that offer meaning and purpose. You don't have to provide explanations to clients for why the market didn't do what you said it would do and can rest easy once you come to understand that "this is what the market always does."