On Course Financial Planning

Facing the Future with Optimism and Courage

September 2020 Vectors

geo@oncoursefp.com 425-861-9997

The Cash Panickers

On February 19th, the S&P 500 topped out at 3,386 - its 13th new all-time high in 2020. Happy times. The 14th new high for the S&P 500 came on August 18th, when it closed at 3,390, making all prior market declines temporary interruptions in a long-term upward trend in stock prices. So, had you traveled to an isolated island for a six-month sabbatical on Feb. 20th and returned home on August 19th you would have assumed that nothing much happened in the stock market or economy while you were away. Yet, the interim period included a pandemic driven shutdown of the global economy and the quickest, deepest short-term economic contraction in history. Real (inflation adjusted) gross domestic product fell faster during the second quarter than in any quarter since the Great Depression and the S&P 500 fell 34%. Then, unexpectedly, the S&P 500 rebounded with its best five-month percentage gain since 1938. Both the decline and the recovery were unimaginable on February 19th, the latest example of why attempting to time your way into and out of the stock market is a fool's errand.

Let's review some simple middle school arithmetic. The percentage gain needed to recover from a loss will always be greater than the percentage loss. After falling 34%, the S&P 500 had to rise 52% to erase the loss. Six month, 52% gains are rare occurrences, which is one reason why I'm an advocate of having an appropriate allocation to U.S. Treasury securities and high-quality corporate bonds in your portfolio – what I call "portfolio shock absorbers". Even when offering below inflation yields, they serve two important functions – they moderate portfolio volatility and are sources of cash for drawdowns during bear markets. Today, the 10-year Treasury note is yielding about 0.7% - less than inflation. But as history has shown numerous times, when money flees stocks, it usually winds up in U.S. Treasury securities.

Today, there is an unprecedented amount of cash on the sidelines, far more than during the Financial Crisis. Vanguard has released the results of its analysis of what it calls "cash panickers" - account owners who sold their stock investments and moved to an all cash portfolio between February 19th and the end of May. The good news is that less than 1% of Vanguard account owners became cash panickers. The average "panicker" was 56 years old and had a pre-panic stock allocation of 73%. Vanguard calculated what the return would have been had the cash panickers kept their February 19th portfolio allocation. According to Vanguard: "*Through May 2020, more than 80% of these cash panickers would have been better off if they had simply "stayed the course"*. An appropriate, permanent allocation to stocks is an essential component of any portfolio. Cash panickers may have experienced short-term relief but by remaining on the sidelines while stocks rebounded, many have now come to realize that they have set their retirement plans back several years.

Imagine that you received a Divine Revelation in January that within weeks a virus will emerge that will shut down much of the global economy. Businesses will close, sporting events will be canceled, daily routines will be altered, travel plans will be derailed, and tens of millions of Americans will lose their jobs. What's worse, there is no vaccine, no cure, and the virus can be contracted via airborne contact. Would you have changed your portfolio allocation? Let's be honest, most of us would have joined Vanguard's cash panickers and still be out of the market, having missed a 52% gain. It required an ongoing effort to overcome the fear that caused so much stock market volatility in February and March. But cash panicking accomplished nothing. The world didn't end. This time wasn't different. The long-term, goal focused investor's best strategy continues to be to stay the course and, if possible, invest a little bit more every month to take advantage of lower prices.

The first half of this year taught us just about everything we need to know about successful investing. What happens on Wall Street in any given day, week, month, or year is of little significance to a family's long-term financial plan and wealth accumulation program. It's easy to understand why investors flee to the "safety" of cash during times of frightening market volatility. But cash is not an investment. Cash preserves nominal capital (dollars), not purchasing power, which is eroded by inflation. Even the shrewdest investors cannot escape the long-term loss of purchasing power of cash, cash equivalents, and short-term Treasury securities. This year's cash panickers now find themselves in a quandary, wondering when it will be safe to reenter the stock market. Unfortunately, the best time to reenter was when the news was still bleak and there was no light at the end of the tunnel. This is the latest example of why a passive, buy and hold strategy is so much easier on the mind and so hard to beat.

I’ve heard for years that during market declines, active managers can protect fund shareholders by deftly moving from stocks to cash or bonds. According to Morningstar's latest Active/Passive Barometer report, that benefit failed to appear during the first six months of 2020. In an analysis of 4,400 mutual funds, Morningstar research found that just 48% of domestic stock funds outperformed their index fund competitors. In only two (small-cap value and small-cap growth) of the nine asset classes into which Morningstar divides the US stock market were active managers able to outperform their index competition. The idea that active management shines during bear markets endures because it seems reasonable and so many of us wish it were true.

Good news occurs gradually and rarely makes headlines, while bad news is proclaimed in large font headlines. At the onset of any crisis, "suspicious experts" (Nassim Nicholas Taleb's apt description) who don't know any more about what the future holds than anyone else, will appear in the financial media proclaiming the end of life as we know it. Each day, there is good news and bad news. There will always be reasons to delay investing in the stock market, to stay on the sidelines until things “get better” - a phrase that has no definition or identifiable point in time.

The rebound in the S&P 500 reflects recent good economic news and the expectation that the economy will continue to improve, though the pace of improvement is uncertain. Auto and home sales are strong and the unemployment rate is declining. Gasoline sales, which were 50% lower than one year ago during Easter weekend, were just 7% lower than one year ago during Labor Day weekend. The economy may not be the same when the pandemic is behind us, but we are a resilient people, we will persevere, and we will adapt. Perhaps the lesson we can learn from all this is that the financial media is a source of sound, which is not the same thing as saying that it is a source of sound advice. My advice is to ignore the daily media noise and use the extra time to study history. It will provide a needed dose of perspective which will greatly improve your decision-making ability.

In the News

With the presidential election just around the corner, economics and politics are daily media topics. Economists and politicians face the same problem – what everyone wants adds up to more than what there is. Economists tell us that in a free market, prices solve this problem. Prices reach equilibrium at a level that balances supply and demand. Politicians do not like this answer. Instead, they increase the demand for everything by promising to give us whatever we desire for free. It is almost impossible to predict what will happen in the economy because it requires knowing what politicians will do. Good luck with that.

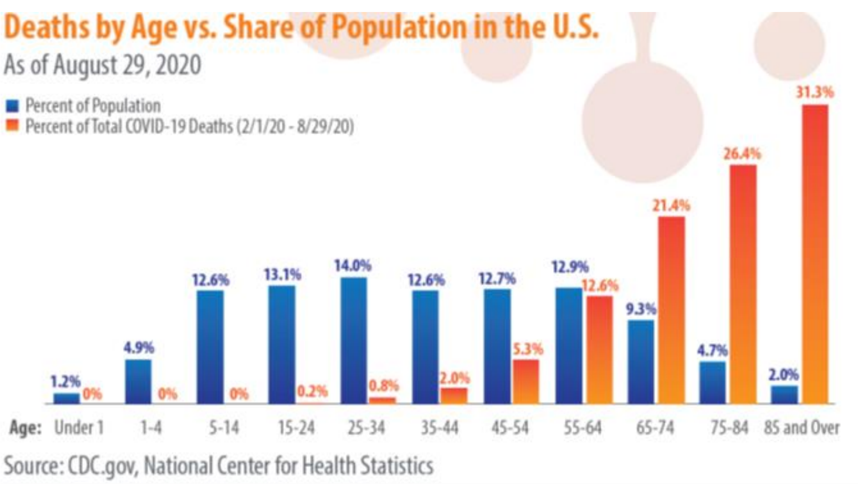
Every so often, a video proclaiming the imminent end of our economy or a stock market collapse of Great Depression proportions goes viral on YouTube. It's not uncommon for a financial advisor to receive an email from a client with a link to the video and a request for comment. Don't bother sending me any links. Here's my answer – "It could be true, but I doubt it." Perhaps after three bear markets in the past 20 years, investors have become so frightened of losses, even temporary ones, that they cannot resist these warnings of doom. There are numerous, well known "perma-bears" who make ongoing gloom and doom stock market predictions. Unfortunately, they seem to have standing invitations to spread their pessimism in the financial media. Many have been predicting economic calamity since 2008 – hoping that someday they'll be able to claim, "I was right!" Many investors subscribe to their newsletters. Unfortunately for these subscribers, the perma-bears have been wrong more often than they have been right. But this is nothing new. Philosopher and political economist, John Stuart Mill, wrote 150 years ago: *"I have observed that not the man who hopes when others despair, but the man who despairs when others hope, is admired by a large class of persons as a sage."*

Investors must make a clear distinction between uncertainty and risk; they are not synonymous. Risk exists when probabilities are known. For example, betting that your lucky number will come up in the spin of a roulette wheel has a known probability of success. The possibility of loss is a known risk. Uncertainty exists when there is no way to calculate the probability of an outcome. It is uncertainty, not risk that makes predicting the stock market a daunting task.

Many people get great satisfaction from their work. If that's you, you might not be looking forward to retiring. But don't think of retirement as a time when you stop working. Think of it as a time in life when income producing work becomes optional, when quality of life decisions become more important than income. Think of it as a time of financial independence when you can do things that you enjoy in the time freed up by leaving full time labor.

Using the Federal Reserve’s Survey of Consumer Finances, DQYDJ.com (Don't Quit Your Day Job) offers a calculator that reveals how your net worth—either with or without home equity—ranks relative to your fellow Americans. It also has calculators that reveal how your individual income or your household income compares to other Americans, and how your income compares to those who are your same age.

Last month, the Federal Reserve adopted a significant shift in its interest-rate policy that places more emphasis on boosting employment, even if this means allowing inflation to rise above its 2% target. The Fed is promising to keep interest rates at today's historically low rates even as the economy recovers to pre-pandemic levels. This will benefit borrowers at the expense of savers for years to come. *"A robust job market can be sustained without causing an outbreak of inflation,"* Fed chairman Jerome Powell said during the Fed's annual conference in Jackson Hole, Wyoming last month. Under the new policy, the Fed would target inflation that averages 2% **over time**. If inflation stays below 2%, as it has for most of the past decade, the Fed will allow inflation to run *"moderately above 2% for some time,"* Powell said. In other words, the Fed will not preemptively raise interest rates as the unemployment rate falls unless there is an increase in inflation. By promising to hold interest rates at today's levels for an extended period, the Fed is discouraging people from holding cash and short-term investments and incentivizing them to spend and borrow money at today's low rates to boost the economy. Buoyed by low mortgage rates and pent-up demand, housing activity, a traditional leading economic indicator, has surged. Retail sales have surpassed pre-Covid levels, thanks to pent-up demand, generous jobless benefits, low interest rates and stimulus checks.



This chart is from First Trust, using CDC data through August 29th. The blue bars represent the percentage of the US population of each age group and the orange bars represent the percentage of total Covid deaths experienced by that age group. Note that 79% of all Covid deaths occurred among people 65 and older (16% of the population) and that 3% of Covid deaths occurred among people under 45, (58% of the population). This fact is unknown by almost all our fellow citizens which helps explain why perfectly healthy young people can be seen wearing masks while walking alone, bike riding or jogging outdoors.

If these numbers surprise you, join the crowd. Franklin Templeton and Gallup teamed up to produce the "Franklin Templeton – Gallup Economics of Recovery Study". Gallup surveyed 10,000 US adults between July 2 and July 14, 2020. The report focuses on what it calls "misperceptions of risk" – Americans dramatically misunderstand the risk of dying from Covid-19 –

- On average, Americans believe that people aged 55 and older account for just over 50% of total Covid deaths. The actual figure is 92%.
- Americans believe that people aged 44 and younger account for about 30% of total debts. The actual figure is 2.7%.
- Americans overestimate the risk of death from Covid for people aged 24 and younger by a factor of 50.

The report identifies two major culprits for the misperceptions of risk – the quality of information available and the extreme politicization of the Covid–19 debate. The report notes: *"Mortality data have shown from the very beginning that the Covid-19 virus age discriminates, with deaths overwhelmingly concentrated in people who are older and suffer comorbidities. This is perhaps the only uncontroversial piece of evidence we have about the virus. Nearly all US fatalities have been among people older than 55; and yet a large number of Americans are still convinced that the risk to those younger than 55 is almost the same as to those who are older… This misperception translates directly into a degree of fear for one's health that for most people vastly exceeds the actual risk: we find that the share of people who are very worried or somewhat worried of suffering serious health consequences should they contract Covid - 19 is almost identical across all age brackets between 25 and 64 years old."*

People's behavior in response to the pandemic will play a crucial role in shaping the path of the economic recovery. Overestimating the individual danger posed by the virus will lead to a deeper and more prolonged recession. In summary the report noted "*From a public interest perspective, we believe the top priority should be better information and less partisan, more fact-based public debate. It is shocking that six months into the pandemic so many people still ignore the basic mortality statistics, with perceived risk driven by political leanings rather than individual age and health. Misperceptions of risk distort both individual behavior and policy decisions*."