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Cadence *clips*

FOCUSED ON WHAT MATTERS MOST.

The Cost of Panic Revisited

We had a piece in the September 2013 Cadence Clips called "The Cost of Panic". In it, we showed how investors who panicked and deviated from their investment plans when stock prices dropped from 2007 to 2009 caused irreparable harm to their wealth. We have certainly seen a shock to global stock markets this year, with the potential for more losses to come. As of this writing, many asset categories have bounced off their recent lows giving investors an opportunity to breathe a bit. Many are asking themselves if now would be a good time to get more aggressive, while many others are wondering if this is just a pause in the downward cycle and if it would be a good time to get more conservative to reduce losses that may start again sometime soon.

It's understandable that investors wonder where to go from here after a shock to the system. That's a normal emotional reaction to losses. To show the potential impact of acting on emotional impulses during rapidly declining asset prices, we will revisit and update that September 2013 piece to illustrate the risks of adjusting investment strategy based purely on the kind of stock price changes we've seen recently. The other piece in this month's newsletter lays bare the meaningful distinction between stock <u>prices</u> and stock <u>values</u>. For example, values frequently go up as prices are dropping. Unfortunately, the lion's share of investors make moves based on price changes as opposed to value changes.

As our clients know by now, properly allocating an investment portfolio takes many things into account, namely timeframe, ability to survive a loss of a given size, tolerance for risk, and where asset values are at this point in time relative to where they may go over the investment timeframe. You're more likely to prioritize protecting your assets when asset prices are expensive relative to their value as they've been over the past few years, while you're more likely to feel better about getting more aggressive with your allocation, or at least you should, after a meaningful drop in asset prices relative to their values.

The three investors in our September 2013 newsletter had all allocated their portfolios half in US and foreign stocks, and half in US and foreign bonds. More than likely, that is NOT the allocation we would have recommended for at least two of the investors. Instead of taking into account the factors we identified above, most investors look at past price changes in assets to decide how much of each asset class to own going forward. By late 2007, looking backwards only would have led many people to take more risks than they should have, which has also been happening for the past few years.

We're going to assume one investor stayed with his or her planned 50/50 stock/bond mix over the entire period, October 2007 to March 2020, and we are going to nickname that person "Stay the Course".

We're going to assume a second investor sold all equity positions at the end of October 2008 as markets were crashing hard, invested that portion in the bond market instead, and finally got comfortable enough to get back into the stock market early in 2013. We're nicknaming this person "Harmful Panic Level". With a name like that, you can probably see what's coming for this investor.

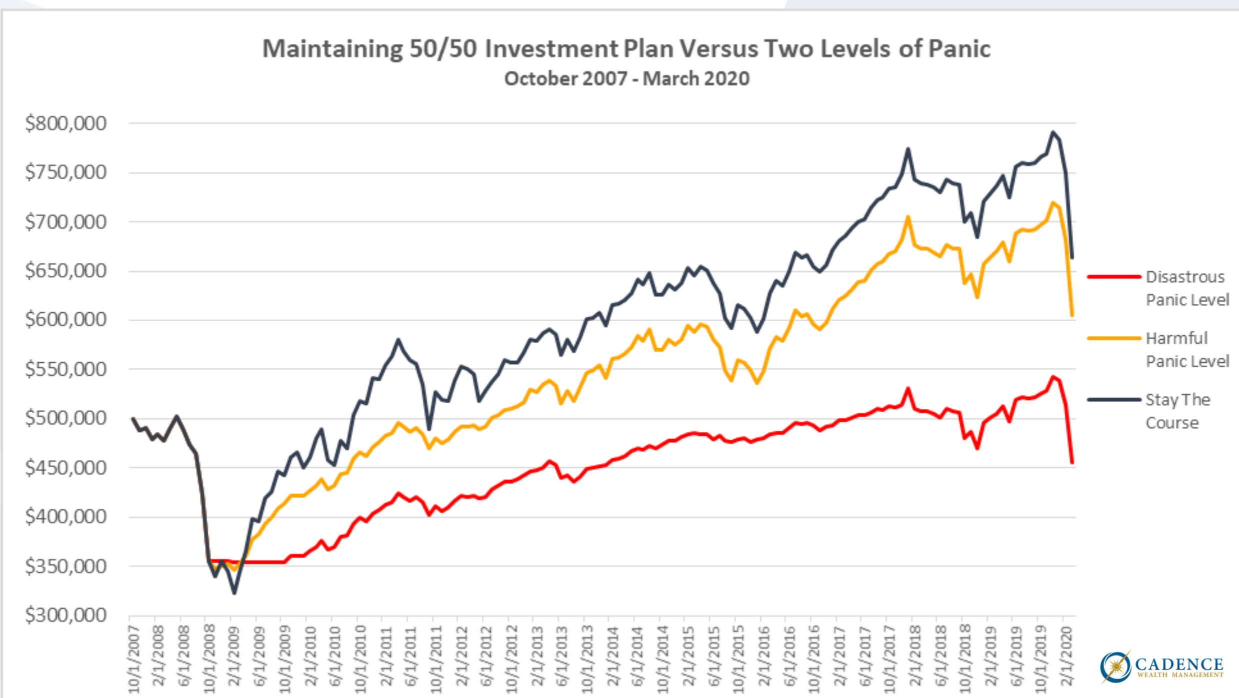
Finally, we're going to assume a third investor panicked, liquidated everything and left it in cash in late 2008, found the way back to bonds a year later, and eventually got pulled back into stocks in early 2018. We'll nickname this person "Disastrous Panic Level". With a name like that, you can definitely see what's coming for this investor, and are probably already feeling a bit badly for him or her. That shows you're a good person, which doesn't surprise us.

To summarize:

Investor 1 "Stay the Course" – Half stocks, half bonds the whole way through.

Investor 2 "Harmful Panic Level" – Switched to bonds and then back to half stocks, half bonds.

Investor 3 "Disastrous Panic Level" – Switched to cash, then to bonds, then back to half stocks, half bonds.

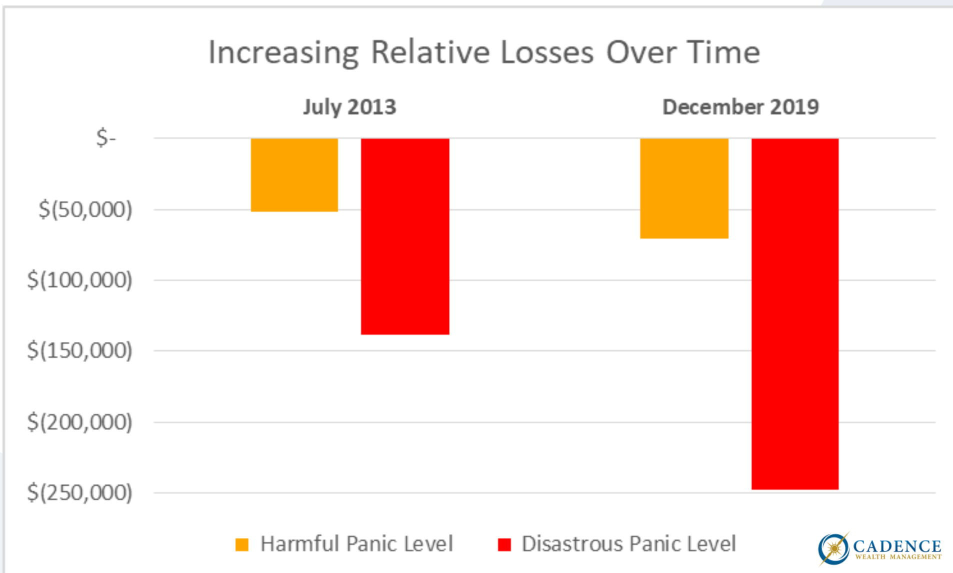


"Stay the Course" made no changes to his or her investment mix, which means he or she possibly had the right allocation from the beginning. By not panicking, the assets were able to grow 6.5% per year from when they bottomed out in 2009 through this March.

“Harmful Panic Level’s” changes did some damage. By trying to preserve his or her assets and abandoning stocks completely for a while, he or she reduced returns from the 2009 stock market bottom from 6.5% to 5.1% per year.

“Disastrous Panic Level”, unfortunately, has done some incredible damage. The bouncing from cash to bonds and then finally back to stocks when valuations were actually warranting less stock exposure as opposed to more dropped returns from 6.5% all the way down to 2.3% per year. What’s even worse is that the ending balance as of March 2020 is actually lower than it was at the start back in October 2007. This illustrates how dangerous the right intentions mixed with the wrong allocation and knee-jerk reactions are for many people.

If you were already feeling badly for our two panicky investors, this next bit isn’t going to help. There’s some sinister math to all this that can allow mistakes to grow over time. By the end of July 2013, these two investors’ portfolios were ~$52,000 and ~$138,000 worse, respectively, than our “Stay the Course” investor. However, over time, those relative differences have increased:



What this chart shows is that the dollar value of investment mistakes can grow over time. “Harmful’s” relative loss grew by 36%, from about $52,000 to over $70,000 between the middle of 2013 and the end of 2019. That’s around a year’s worth of retirement expenses for many people. “Disastrous’s” relative loss increased by nearly 80%; from around $138,000 to a whopping $248,000. That’s easily three years’ worth of retirement expenses for many people.

What we hope this illustrates is the benefit of having a plan consistent with your tolerance for risk, financial needs and timeframes, and where we are in the investment cycle. As long as an investor understands how much their investments may lose during a downturn and can both afford to be down that much and also sleep at night, then there are clear advantages to sticking to the plan.

You know how the best time to plant an acorn was 20 years ago? The best time to get your investment mix right is BEFORE a market crash. Now, it is possible that investors tried their best to create an asset mix that took into account all that was important to them and are unfortunately finding out their tolerance for risk was lower than they thought, or their understanding of where asset values were was off, or perhaps they cannot afford as large of a loss as they thought they could. Like at any time, they need to get the proper measurement of these plus, at the very least, their needs and timeframe, and not make changes solely based on what happened during the recent drop. Nobody should knee-jerk some reactions and become "Harmful Panic Level", and at all costs, should avoid becoming "Disastrous Panic Level". If this year's asset price drops made you seriously question your investment allocation, it's best to figure that out before a continuance of this year's investment losses causes you to panic.

However, for those who weathered this year's storm and feel like they are positioned well to handle further market drops, then the recent price declines may already provide selective opportunities to acquire some investments at favorable valuations, which we have already started doing for our clients. As the other piece in this month's Clips highlights, wholesale risk increases probably aren't yet appropriate to pursue, but unique value opportunities could start to present themselves sooner than later. Some already have. While there is a definite cost of panic, investors who get their mixes right are in a position to actually enjoy the benefits of other people's panic. Just because you felt badly for "Disastrous Panic Level", that doesn't mean you shouldn't consider buying assets from him or her at the right price.

When Will Stocks Look Attractive Again?

When we look back 100 years at the relationship between the size of the stock market and the underlying economic fundamentals either by way of gross domestic product (GDP) or the amount of "stuff" that corporations produce (Gross Value Added), there are two things we can learn. First, stocks tend to rise with economic output. Makes perfect sense. Corporations do well, people do well, the economy does well, stock prices go up. The second observation however, which is far more important to investor performance over time, is that stock prices tend to rise faster than economic output when times are good and fall faster than economic output when times are hard. In other words, valuations get stretched in good times and contract beyond reason in hard times. For long-term, more buy-and-hold portfolio strategies, this is probably the single most important investment concept to understand.

Today, despite recent market turmoil, stock market valuations are stretched. In February of this year, U.S. stocks were in record expensive territory per a host of measures and today we only stand a few percent below those dizzying heights. Based on the 100-plus year relationship between the size of the stock market (market cap) and the underlying economy, if prices were to revert back to average levels over the next ten years, the S&P 500 would be at $2,664. It's at $2,878 as of this writing. With dividends, that would put the average annual return at just about 1%...per year. This assumes the economy continues to chug away at 4% nominal growth per year and dividends continue to pay out at 2% of today's market value. It does not take into account the sharp economic contraction we're facing at the moment that very well could pull down that 4% GDP growth rate over the next ten years.

And so, this 1% total return for the S&P 500 is a very average scenario in a world that is anything but average. We've been witnessing the risk of a better than expected outcome play out over the last few years based on historical norms. The market returns we've witnessed the last few years are not normal by any stretch. The fact that valuations are so rich makes this fact obvious. Investors need to be keenly aware of the equally probable risk of a reversion of valuations beyond the mean into below average territory. This would lead to returns below 1% over the coming 10 years.

This aside and more relevant to our clients right now is the question "How much do stocks have to fall before they start to look more appealing?" With simple math and a few reasonable assumptions, we can answer this question.

First, the assumptions:

- The economy will grow at an average of 4%. If we assume official inflation of 2-2.5%, this puts us right where real (inflation adjusted) GDP has been over the last 10 years. It's worth noting that we view this as a rosy scenario. It's what we've done over the last ten years of good times. What happens to this number with a recession or two thrown in? We'll tell you: It goes lower. Between 1929 and 1933 the economy declined 46% in nominal terms. That certainly impacted stock valuations just as a meaningful retreat in GDP would affect them negatively today. Again, for now we'll err toward an optimistic outcome and assume we average 4% over 10 years.

- We assume dividends will continue to be paid at the current rate of 2% of the S&P 500, or roughly $57 based on a value of $2,878. When the S&P 500 falls, that dividend yield goes up since the same $57 will be paid on a lower index value. Again, this could be viewed as a rosy assumption since it doesn't reflect dividend cuts throughout the downward part of the business cycle.

- As we stated, we assume ten years from now markets end at average valuations. This does not take into account a retreat below average which we'd consider very likely given ample historical precedent. It also doesn't take into account the timing of markets getting back to average. This could happen sooner or it could take longer. We use ten years simply because of the very sound long-term correlation between valuations and subsequent market returns. Although valuations have no bearing on where markets will be in 6 months or even 2 or 3 years, they do provide more visibility around where markets will likely be over 8-12-year time frames. Valuation cycles take time the same way any other cycle does.

- Finally, we are only using data going back to 1963 for simplicity. This data set is skewed toward better market returns which has the effect of raising the average valuation level a bit higher than it probably should be. The price-only return for the Dow Jones Industrial Average from 1900 to 1964 was 3.8% versus 6.1% from 1964 to present. Add dividends and we're probably a bit closer since dividends were higher back then than today, but some skew probably still exists. The result again could be that average is really a bit further down than we're illustrating here.

With all that, here's where we end up:

Market Loss From Here	S&P Value	Likely Return Over 10 Years
-10%	2590.20	2.5%
-20%	2302.40	3.8%
-30%	2014.60	5.4%
-40%	1726.80	7.2%
-50%	1439.00	9.5%
-60%	1151.20	12.4%
CADENCE WEALTH MANAGEMENT -70%	863.40	16.3%

As we can see, if stocks (S&P 500) drop another 10% from here, then one could reasonably expect to earn a little more than they could from U.S. Government Bonds over the next 10 years – 2.5%. If they drop 40% from here, then we're back up to a respectable 7.2% annualized total return. It's not until we get over 50% lower than stocks are today that we get back to what we'd consider solid long-term returns of over 10%.

So when should one venture back into stocks? It really does come down to how much return it takes to compensate one for the short-term risk of investing in stocks. From a long-term buy and hold perspective, we'd probably start to pay attention after another 30% drop in prices. We'd probably get back to more "normal" portfolio allocations after a 40-50% decline, while we'd start to get genuinely excited about truly generational opportunities in the stock market (again, S&P 500) after anything more than a 60% drop. Valuations at that point would be far enough below average to provide a very reasonable margin of safety over the short term and very compelling reward over the longer term. Quite simply, the math would work.

As we already mentioned, volatile markets stir our emotions. They're difficult. Making long-term financial decisions while staring at short-term fluctuations can be truly paralyzing. What makes it easier is having good data and a solid historical perspective. Knowing oneself is also crucial. Are we able to stay grounded in the data and math along the way or are we more susceptible to the shorter-term noise? Knowing this can help one to prepare and be more self-aware when times get tough. Understanding that what happens today with any particular investment has no bearing on where it's likely to end up can be empowering. It helps us see through the noise of day to day movements and focus on the big picture.

There are attractive investment opportunities right now that we've spoken about. We are excited about those. When it comes to stocks on a market-wide basis, our excitement lies in knowing they will be attractive at some point down the line – possibly very attractive. We know the math which helps us immensely with waiting. It will not only keep us out of trouble, but help us to make smart decisions. When the time is right for our clients, we'll be ready; to take a little action at first. Then, possibly a good amount more.