June 1, 2017

Don’t get too caught up in a Trump bump or slump

Political issues shouldn’t play a large role in long-term strategy

There’s one certainty about the stock market. It’ll go up and down.

Last month, we witnessed this as the markets declined after a series of controversies in Washington. It wasn’t so much the controversies that sent a shudder through the markets, though. It’s that they affect the chances for tax cuts and regulatory reform, which have been credited for the Trump “bump” in stocks since election day.

But you could also credit strong corporate earnings, which in Q1 showed the largest quarterly increase in several years. Or you could point to economic factors which suggest continued moderate growth and inflation. Most of the post war recessions in the US have been triggered by a too rapid increase in interest rates, but given moderating employment growth and the modest increase in Q1 GDP, it appears likely that the Fed will raise rates cautiously as warranted.

Plus, many investment and media sources give the impression that the post-election rally counts as “Irrational Exuberance,” but here’s another perspective. Stocks may be making up for a two- year period of below average returns prior to the election. As the chart below shows, the representative Vanguard Total Stock Index Fund (VTSAX – blue line), had a below average annual return of just over 3% in that period. And the Vanguard Total International Stock Index (VTIAX – yellow line) had about a 2% annual loss. The recent rally has served to bring the two and three year returns up to average, which hardly counts as exuberant.

Maybe the question to be asking isn't whether the Trump bump will slump, or not. Rather, the correct question is, should you be engaging in market timing around political inputs?

While there's always a chance that guessing right might pay off, and it might feel good to relieve uncertainty around the country's current political climate, timing the market is not likely to prove successful over the long run, especially if you assess results including cash drag, taxes and transaction costs. Beating a buy and hold strategy would require guessing right repeatedly over the course of an investment lifetime. There is no evidence in point or in fact to suggest that any investor, individual or professional, can consistently outguess millions of well-informed competitors about short-term market movements.

Following such a strategy is like trying to beat the house at its own game. You might be lucky occasionally, but the surest way to beat the house is to play the long-term odds, and refuse to play the market timing game in the first place.

Our belief is that investment decision-making should be focused on things you can know and control. No one can know consistently what's going to happen next quarter or next year in politics, the economy or the market. In any given twelve-month period, the stock market has a 73% chance of rising and a 27% chance of declining. And, just like flipping heads or tails on a coin toss, the odds for a rise or fall are exactly the same in each successive year, independent of the prior results.

Success relies on accepting this uncertainty and managing the trade-off between risk and return by selecting an appropriate asset allocation between stocks, bonds and cash based on your goals, time horizon, risk tolerance, need for liquidity and financial risk-taking ability.

Note that "time horizon" is not the same as time to retirement, but rather the time until you'll need to withdraw a substantial portion of your portfolio assets. The concept of time horizon in investing is related to liquidity risk – in other words, no one knows when the market will rise or fall, so you don't want to be in a position of having to sell highly variable assets when prices are down. Your plan and your mental approach go hand in hand, and should be set up so that you're unlikely to be forced to be a seller in a buyer's market.

Once you decide on the right allocation -- the right trade-off between *seeking return and avoiding risk, which may be defined either in terms of volatility or the possibility of permanent loss* -- your attention should be on the factors you can control. One of the things we have a great deal of control over is making sure that we're spending within a plan, and saving enough to achieve financial security, and to meet shorter term goals.

Another factor within our control is how widely risk is diversified within equities, fixed income, and other investments. Risk can be defined either as the possibility of permanent loss, or as the relative amount of volatility in a portfolio. When you hold concentrated positions in employer stock, or in other individual securities, you're taking "unsystematic" risks. That may pay off in the form of higher returns, but it also exposes you to business specific risks and the possibility of permanent loss if things go bad.

By choosing to diversify widely enough, say by owning index funds in each asset class, you can virtually eliminate business specific risks. Your risks are then "systematic" (market risks) and may be defined in terms of relative volatility – the ups and downs of each asset class. Risk can be managed effectively primarily through asset allocation, by mixing different asset classes (such as stocks and bonds) to construct an acceptable trade-off between risk and return. To a lesser extent, risk can also be mitigated by mixing different types of securities within an asset class. For example, within bonds, interest rate risk can be mitigated by owning various maturities and by owning credit sensitive bonds. Equity risk can be reduced by owning various countries, market caps, selection styles, industries, etc. The idea is to own securities that perform differently in various phases of the business cycle, obviating the need to guess which will outperform next.

The chance of a permanent loss is mitigated by "time diversification," by bucketing or matching the riskier stock allocation to longer dated financial needs, reducing the chance you will need (or be forced out of fear) to sell during a downturn. Stocks historically experience periodic downturns, some worse than others, but have a perfect record of eventually recovering. Lengthening the holding period reduces the chance that you'll have a negative return. The chance of losing money in the S&P 500 Index in any given year is 27%. That chance drops to 5% over ten years and 1% over fifteen years.

Time Diversification

Odds of Losing Money: 1928-2015

	100% Stocks			50% Stocks/50% Bonds		
Rolling Periods	Winning Periods	Losing Periods	Odds of Losing	Winning Periods	Losing Periods	Odds of Losing
One Year	64	24	27%	69	19	22%
Five Years	72	12	14%	79	5	6%
Ten Years	75	4	5%	79	0	0%
Fifteen Years	73	1	1%	74	0	0%
Twenty Years	69	0	0%	69	0	0%

Asset allocation and diversification are all about managing exogenous risks, but a savvy investor appreciates how behavioral risks also might result in missed returns and significant losses. Sticking with an investment program long enough for the laws of averages to work in our favor is hard, which is why the payoff is so great!

Compliance with an investment strategy is increased when it is grounded in a sound financial plan, and when the client has confidence that the asset allocation hits the right trade-off between risk and return. That's why we place so much emphasis on the process for matching clients with the right asset allocation. That's also why we always put financial planning before asset allocation.

As part of that process we hope to complete an "Asset Allocation Matrix" for each client. An objective risk tolerance score is important, but we also seek a subjective understanding about how a client has made investment decisions in the past. We've developed a financial risk capacity scoring system that assesses a client's ability to stay with an investment program based on an analysis of lifetime cash flow and liquidity needs, income statement, balance sheet and insurance programs. We're also able to assess the impact of various investment allocations on the financial, and stress test the validity of the plan under adverse market or economic conditions.

What's the right allocation? One of our clients recently quipped, perhaps the right asset allocation should feel a bit like "kissing your sister," it won't get you excited, but you won't lose sleep over it either!

Once you have an asset allocation plan that engenders confidence, it is important to implement it in such a way as to minimize "opportunity costs," the chance that you might miss out on returns through too much intervention. Making mostly passive investments in index funds will ensure that you consistently capture the returns available in each asset class over time, without the risk of underperforming (active management risk). *That's critical because, when you approach investing from the perspective of a financial plan, what you're trying to do is decrease the range of potential outcomes* *in that plan 20, 30, 40 years or more from now. The future holds many uncertainties, but the possibility of underperforming bond and stock markets should not be one of them.*

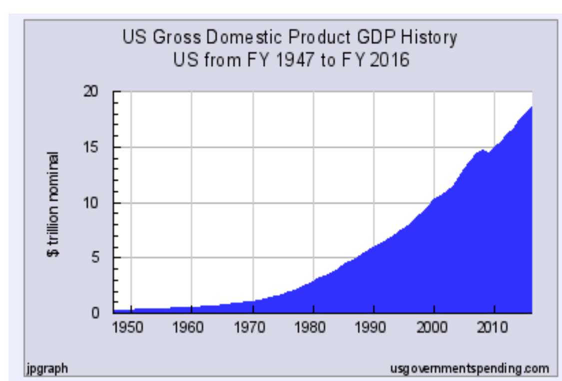
It's also important to control investment costs and taxes, as they add up over the long run, by trading infrequently and investing the core of a portfolio in low cost, tax efficient index funds. We also look to tax loss harvesting when possible, and locating and distributing assets in tax sensitive ways.

Risks associated with highly priced markets can be mitigated by faithfully rebalancing the portfolio. That means selling some of the winning assets and buying some of the lagging ones. A portfolio should be reviewed continuously for rebalancing opportunities, but rebalancing too frequently runs up investment costs and robs a portfolio of the benefits associated with momentum. We can't predict momentum in markets, but it is clear that trends are sticky.

If we focus on managing these things we can control – asset allocation, diversification, expenses, psychology, prices (rebalancing), taxes and how much we spend or save – the odds will already be in your favor and you won't need to guess about things you cannot possibly know, like whether there is apt to be a market slump or not.

Planning first puts the focus on winning your own game – realizing your financial goals – and not on buying and selling in attempts to win the market game, which is stacked against you. In fact, over time you will likely take advantage of (take return from) those players who aren't so disciplined, and who often are forced to react to short term developments. For those players, the importance of every piece of news and every bump in the road will appear magnified in proportion to the actual significance, and will obfuscate the miracle of compounding over the long run.

To illustrate this point, here are two charts measuring the same data point – US Gross Domestic Product. The left chart shows the change in Gross Domestic Product growth from quarter to quarter. Notice how volatile the swings in GDP growth are, but also that none of the swings are persistent or particularly predictive of the economy. The chart to the right shows the total annual GDP from 1947 to 2016. Despite quarterly swings, annual GDP increased from about $300 billion to nearly $18 trillion over that time period. You could substitute similar charts for corporate earnings or the stock market, the perspective would be similar.



The bottom line is that focusing on short-term trends driven by economic and political machinations might deprive you of the returns that investors have *earned* – that word is italicized for a reason – by committing their capital over the years to corporations which have prospered mightily *despite presidents, tax policy, and regulatory schemes*.

Wall Street and the news media want you to focus on the short term because that's what pays their salaries. Many investment advisors give advice based on short-term indicators either because their compensation is tied to it, or they're afraid they'll be fired if they don't predict the next bear or bull market. They're on a weaker psychological footing than the people they're managing money for.

The breathtaking increase in GDP and the stock market over the years, reminds us that Presidents are temporary, but hard work, ingenuity, innovation and productivity are deeply ingrained in our country and, indeed, those same qualities exist around the globe as well.

It would be great if Washington could get together, set aside their differences, and reform our overly complex tax regime, while also leveling the burden. And it would be even better if they could get rid of unnecessary red tape for businesses and individuals, while retaining critical regulations that protect citizens and the environment.

But your investment strategy doesn't depend on it. Nor will the success of your financial plan be greatly affected if the market gives back everything it has gained since the election.

As far as turning over an investment portfolio in response to political risks, here's an admittedly extreme illustration to drive home the point. The chart below traces the growth of an initial $10,000 investment made in the Vanguard Wellington Fund, which invests about 60% in stocks and 40% in bonds, on the day Congress began impeachment proceedings against Richard Nixon. From February 6, 1974 to May 20, 2017, that investment grew to $828,000 with dividends reinvested. Past performance is not a guarantee of future results.