# Managing the Unprecedented: What Investors Need to Know Now

PARTICIPANT QUESTIONS

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*This webinar was not recorded.*

MODERATORS
**Darius Gagne, PhD, CFA, CFP®** Chief Investment Officer & Partner, Abacus Wealth Partners
**Apollo Lupescu, PhD** Vice President, Dimensional Fund Advisors

## Buy/Sell, Rebalancing & Market Timing

**Q: Please talk about the opportunities for buying now.**

**A:** The primary opportunity we are recommending is rebalancing. Your stocks are most likely sharply down for the year, while your bonds have probably held relatively steady. This creates an opportunity to buy more shares of stock at relatively low prices by selling bonds, until your stock/bond allocation is back to its investment plan target that you and your advisor agreed to. The most important thing about an investment plan is having one and sticking to it.

Another opportunity we are seeing is "tax loss harvesting." This means selling stocks or funds that are down, but immediately replacing them with similar stocks or funds to maintain your exposure while booking a loss that can be used against future realized gains.

Most of the popular opportunities one hears about right now -- such as buying medical equipment stocks -- are ideas the market is fully aware of and has priced in, so there is no real advantage in pursuing these opportunities.

**Q: But what about selling high and buying low? Isn't there a tremendous opportunity to buy in while prices are so low? Wouldn't it have been 'smart' to have sold in late April and to be buying today? Doesn't 'never' selling make this kind of scenario impossible?**

**A:** We take advantage of this through rebalancing. Rebalancing is the process of bringing your portfolio back to the mix of stocks and bonds that you and your advisor have agreed is most appropriate for you. As stocks have declined this year and bonds have held relatively steady, we have generally been selling bonds to buy more stocks at a steep discount to prices from earlier this year. When the market eventually recovers this will be a benefit to our clients.

In hindsight, it would have been great to sell last April and then buy now. Unfortunately, we know we can't time the markets and we don't believe anyone can on a consistent basis.

**Q: What's wrong with selling when we realize the markets are going to go down?**

**A:** There is nothing inherently wrong with this, if we know when to get back in. Both are, in fact, very difficult to time. The data shows us the challenge with this strategy is most people tend to sell at the very bottom of the market, only to see the markets turn positive -- making the decision to re-enter the markets that much more difficult all while missing out on strong market returns. In addition, there will usually be significant capital gains investors will have to pay, which only exacerbates the financial impact in an adverse way.

Also keep in mind the market does not have a present tense. We can only speak of what the market did in the past, or what we expect it to do in the future. It is quite tempting to speak about the market in the present, such as "the market is going down." But this is not a well-defined statement and the act of clarifying the concept often answers the underlying question.

**Q: Abacus says nobody can time the market but I'm not sure it's true. Many financial planners have engaged in planning for pandemic scenarios and sudden decreases in market values. What is your plan going forward?**

**A:** This question touches on two topics: investment/market timing and planning.

Let us touch on the investment part first. We know -- with 100% certainty -- that Abacus cannot time the markets (sell before a decline in value and buy before an increase in value). We also believe, adamantly, that nobody can consistently time the markets. While this may not be consistent with what we all hear from the entertainment industry covering the markets, it is a consistent belief held by many of the best and brightest minds in academia.

That doesn't mean nobody could have predicted the recent market decline. In fact, there absolutely will be people who got out of the market ahead of this event. Were those people skillful, or lucky? They clearly fall into the "lucky" category if their rationale for being out of the market wasn't related to a global pandemic. To argue it was skill someone would have to demonstrate not only that they foresaw a global pandemic, but that they knew specifically when it would happen. The timing is extremely important. Using the S&P 500 as a proxy for the market, the market was at today's level around the end of Q3 2017. If someone predicted this situation too early and missed the run in the market between Q3 of 2017 and the peak in February, they were not better off by being "right."

The other problem with timing the market is even if you get the first part right and miss a large decline, you still have to decide when to get back in. If you get that part wrong it may not matter that you got the first part right.

For all of these reasons, our plan going forward is to stay the course.

Now let's switch over to financial planning. While we can't time the markets, we can, and do, anticipate there will be periods like this in the markets. The financial plans we design for clients are built with times like this in mind. Generally, based on your financial plan, your advisor has set you up with enough bonds to weather a storm. Ideally, clients hold enough bonds which can be sold to meet client needs, while we wait for stocks to recover. Please discuss your specific situation with your advisor.

## Portfolio And Asset Allocation

**Q: Could you address what those of us who have seen huge losses in our long-term investments should be thinking about as a strategy? Is there more to do than sit tight?**

**A:** You should talk to your advisor about your specific situation, but Abacus is generally addressing this behind the scenes on your behalf in a few ways. The first way we address swings in the markets is through rebalancing. Rebalancing is the process of bringing your portfolio back to the mix of stocks and bonds that you and your advisor have agreed is most appropriate for you. As stocks have declined this year and bonds have held relatively steady, we have generally been selling bonds to buy more stocks at a steep discount to prices from earlier this year. When the market eventually recovers this will be a benefit to our clients. We are also "harvesting" or realizing losses in our client's portfolios, which can be used in the future to offset other capital gains or even some taxable income.

**Q: Is asset allocation working the way you thought it would?**

**A:** Your plan, at its most basic, is designed to make sure you can spend at your desired level for the rest of your life regardless of what markets may do. In your plan, we assume there will be bear markets. And we set aside enough of your assets in bonds to allow you to draw your spending money from bonds until stocks have time to recover. Your plan is designed to do just that. The plan was never designed to avoid short term losses. If you had no exposure to short term losses, you would have no stocks in your portfolio. Without stocks, your desired level of spending might be lower than desired. Enduring through these short term periods of loss is how we collect the long term benefits of stocks.

**Q: I thought rebalancing would be larger. Why wasn't it?**

**A:** If you have a balanced portfolio (e.g. 60/40) then your decline was less than the market decline. Also, bonds dropped somewhat at the beginning of the health outbreak, which reduced rebalancing opportunities initially. Finally, we have certain tolerance bands that we use for rebalancing. Studies have shown that it's not optimal to rebalance with each relatively small market movement.

**Q: What's the case for/against shifting from 80/20 to 100% stock right now if you have a long horizon?**

**A:** We advise against doing any tactical asset allocation, which a switch to 100/0 would be. The reason is this starts a slippery slope of wanting to go back to 80/20 when the market seems "high." The best allocation is the one that's expected to deliver the required rate of return for you to reach your goals. Consider continuing rebalancing to stay at 80% as corrections lower that percentage.

**Q: The last time I made any significant changes to my asset allocation was Oct 2008 when I doubled my equity exposure. It now seems to be a very good time for long term investors to be buying equities. However, I believe there are also attractive valuations in high yield corporate debt. Where do you see the most attractive opportunities across all asset classes?**

**A:** As you noted, during significant market downturns we will look to buy equities through routine rebalancing. While other asset classes may present attractive opportunities, we believe increasing risk (and subsequently return) should be done on the equity side. Our bond portfolio is constructed with a specific purpose in mind - to serve as a ballast for your plan and weather the storm. High yield debt can be counter to these principles: they have volatility that is more like stocks than bonds, but with returns that are more like bonds than stocks.

## Market Recovery

**Q: How long will the market take to recover?**

**A:** While we can't predict a recovery timeline, we can look at similar downturns in the past and the subsequent recoveries. Observing 30% peak-to-trough drops in US equities from 1926-2019, we know the annualized average returns are as follows: 1 Year (7.14%), 3 Year (8.12%), and 5 Year (11.42%). Markets have demonstrated their resilience over time, and we believe that will continue to hold true.

**Q: What is your opinion of investments in "Emerging Markets" during the worldwide pandemic and the ability of these emerging markets' nations to recover?**

**A:** Year-to-date, emerging markets are down about 3% more than global and domestic stocks since the peak. That means overall the market has priced in a slightly more difficult recovery situation for emerging markets as a whole.

Keep in mind though that around 40% of emerging markets are made up of China and South Korea. Those two countries have been two of the most successful countries at limiting the impact of the virus. China has been one of the top performing countries across the globe this year. Most countries of course can't be like China in terms of locking down their population. South Korea though is arguably the leading example on the right way to deal with this crisis. This is just to say that while we might think emerging markets would have a tougher recovery at first glance, it won't be the case across the board.

**Q: This is unprecedented and I feel like it is worse than we are being told. I am worried the market won't come back the way it has in the past. How do we handle that? Should we be doing something other than riding this out?**

**A:** Our best gauge of what is likely to occur in the economy is the market. The market is a reflection of the opinions of all investors combined into prices. It reflects all that is known and all that can be known about this crisis. As of right now, it is signalling a challenging time for profits in the short term and an eventual return to normality. What can change that outlook? New news can. News in the future is either going to be in line with the market's expectations (no change to prices), worse (prices decline), or better (prices increase).

But here's the thing: no one can predict how that will go. The future is, by definition, unknowable. We have expectations that will be met, exceeded, or missed. And as there are no crystal balls, the market is our best gauge. No one can say otherwise. In the past, every bear market has been accompanied by worries that "this time is different." So far, it never has been. So far, the market, which is full of profit-seeking investors with supercomputers and hired medical experts, does not think this time is different. Betting that it will be different is the riskier bet, by far.

**Q: A number of economists are saying the world economies will not start to recover until there is a coronavirus vaccine. Based on your theory of the value of assets, how would that impact stock prices?**

**A:** As Apollo and Darius discussed, the markets do a good job of incorporating all available information into the prices of stocks and bonds. The fact that the stock market has recently dropped significantly means it is working efficiently to incorporate the expectations of uncertainty around the vaccine timing and recovery of the world economies. As things become more certain around the vaccine and economic recovery, that information will be incorporated into the market and we would expect this to lend to a market recovery as well.

**Q: 1941 was an isolationist worldview and today we have a global economy. Does the parallel hold? The US was a producer for the world, not a service economy. Can services rebound and reposition like production?**

**A:** To use a Mark Twain quote, "History doesn't repeat itself but it often rhymes." Each market downturn has had a unique set of circumstances, and yet, markets have always recovered. The reason for this is consumers continue demanding goods and services and companies are driven by making profits. In more recent economic downturns, we've seen the demand for both services and goods return. Abacus clients own companies around the world, so you'll own companies that benefit from demand and profit for services and goods over time.

## General Investing

**Q: Many companies today are highly leveraged. There is some concern that falling revenues due to the economic slowdown will create tremendous amounts of stress on these companies. Has DFA incorporated leverage into its valuation model?**

**A:** Research shows us that with thousands of investors analyzing companies and buying and selling the stock of those companies based on expectations, the price of a stock does an incredible job of incorporating all available information that's out there (including leverage). The price is central to the valuation models that the mutual funds are built on at DFA, which is the case no matter what economic or market environment we are in. The portfolio managers monitor prices and the information they can glean from them on a daily basis, and update the funds accordingly.

**Q: Why didn't global asset managers, who saw the economic and market disruption in China in January-February, have a better forecast for the global economy and markets?**

**A:** The adjustment in market prices are a reflection of the views and forecasts of all market participants. As new information was becoming available, from China or as the virus spread across the globe, the markets were quickly digesting that and reflecting it in terms of stock prices.

## History

**Q: How did the market respond during the 1918 Spanish Flu pandemic?**

**A:** During the Spanish Flu of 1918, the market -- as measured by the Dow Jones Industrial Average (DJIA) -- dropped approximately 30%, not unlike the response we've seen by the DJIA with the current coronavirus pandemic. After the Spanish Flu, the DJIA recovered to its pre-pandemic level within two years of the bottom. This was, of course, followed by great economic expansion and a strong bull market in the early and mid-1920s.

**Q: I understand free markets and capitalism as points of optimism, but we have never tried to maximize this optimism while the entire population of the world is literally in survival mode. Not just financial survival, but physical life and death. Where are the benchmarks to reference and project based on survival?**

**A:** As you point out, this crisis is unlike any we've seen before. In fact, every crisis is different from the last. Even the financial crises such as the market meltdown in 1987, and the great recession in 2008 are different. As your advisor may have mentioned to you, we do not compare your portfolio returns to any benchmark, but rather focus on whether your plan is set up to meet your financial goals.

**Q: Though I'm confident an effective antiviral therapy or vaccine will be produced, there are no guarantees or timelines. Repeated infections over the upcoming seasons are possible. People may remain quarantined with low consumer spending, businesses suffering, and more prolonged layoffs. Are there historical precedents to help us navigate this potential scenario?**

**A:** We reviewed every major viral outbreak since the Spanish flu (SARS, Bird Flu, MERS, Ebola, Swine Flu, etc.), and while we did not see any one of those outbreaks repeat, anything is certainly possible. However, the markets behave and react based on probabilities versus possibilities; as such, we would rely on our disciplined investment strategy of rebalancing to our allocation according to your financial plan.

In 1987, we experienced the worst single day drop in market history (over 20%) and a combined 34% bear market. That crisis is often compared to the current one in terms of the magnitude of volatility. However, we may not have to look for precedents on how to navigate forward. The current market is behaving essentially as it should under the circumstances, absorbing and reflecting information in real time. And we are already starting to see pivots by companies toward new strategies in this crisis to stay relevant and make an impact.

## Miscellaneous

**Q: Will there be a depression?**

**A:** The market is nothing more than an expression of the collective opinion of all investor expectations for what all companies, collectively, will earn in profits this year and in future years. Right now it sees a difficult short term and recovery. Based on what the market knows today, all that is knowable, it is not predicting another Great Depression.

**Q: What effect will US national debt have?**

**A:** No one can say for sure. But increased debt could result in reduced economic growth in the future, all other things being equal.

**Q: If one can, should we reinvest our stimulus payout ($1200) in US bonds?**

**A:** This would best be answered by your advisor as they would be the most familiar with your financial situation and portfolio.

**Q: The Fed decreased rates to 0%. What else can they do to shore things up? Are treasuries a good thing to be invested in now?**

**A:** In addition to targeting 0-0.25% for the federal funds rate, the Fed has also stepped into markets to buy securities and to lend to businesses. All of these things are done to generally support markets (or provide liquidity) to make sure the financial system functions as efficiently as possible while we deal with the coronavirus.

While there are wide-ranging opinions on the specific details that make up the $2 trillion relief bill, it has been overwhelmingly viewed as a positive step in helping bridge the gap while people are locked down to slow the virus spread. This definitely helped to shore things up and it is possible, or likely, that more will be done in this area.

The right place for any individual to be invested will depend on their specific situation. Treasuries, particularly Treasury bills and notes, are generally viewed as a safe haven (and if you were only invested in these you would have been able to avoid the recent turmoil in the stock market). Of course, the cost for this safety is growth. Most people need some kind of growth to reach their financial goals, or at a minimum to ensure their money isn't decreasing in value over time due to inflation.

**Q: How does this affect municipal bonds?**

**A:** The market is fully aware of the increased pressure that municipalities (and some corporate bond issuers) are under, and this is largely the reason for the drops we saw in bond prices at the beginning of the crisis. Regardless of one's opinion on the long-term effect of Fed actions and government stimulus, it is fairly clear they have shored up the bond markets, at least for now.

**Q: Should I be concerned about high frequency trading and volatility?**

**A:** There's no doubt algorithmic trading has an impact on both intraday volume and volatility, but to the long term investor, the short term volatility these traders may bring has no bearing on their goals. Take the flash crash of 2010 - the moment we all associate with trading programs gone rogue. It was no doubt a disturbing headline but did not even register an impact on the year. The DJIA finished the year up 14%, the S&P 15%, and the Russell 3000 17%.

**Q: What about China?**

**A:** With this virus, we have seen China go from the worst-performing market in the world to one of the best-performing markets in the world. For more information, here is the Economist article that was referenced in the webinar.

Find the rest of the webinar summary on our blog.