March 13, 2020

What do we do now?

The start to 2020 has been a roller coaster. A month ago, few of us had ever heard the term coronavirus. Now it is impacting our daily lives. The purpose of this note is to provide some context regarding your portfolio and a brief commentary about the current situation.

It goes without saying the recent wild market gyrations are uncomfortable. While corrections are normal and in fact healthy, they are never easy. I spend a great deal of time and energy studying portfolio theory and market history and even I find these large market moves uncomfortable. After decades of theoretical study and practical experience, the most effective advice I can offer is to try and become more comfortable with being uncomfortable. More on what this means below.

The term "risk" is a vague term. When someone asks how much risk one would like to take, or how risky an investment strategy is, the best response one can give will be a guess. The term "risk" means something different to each individual and efforts to quantify it are guesses too. Here's my point; what is happening right now is what "risk" feels like. I feel the risk of the market drops and the scary headlines and likely so do you. This is what guides my thinking as the basis of building portfolios for clients *before* a crisis is on the horizon.

So how does someone get more comfortable with being uncomfortable? I believe we need to remember why we are investing in the first place and use history as a guide to think about how things are likely to unfold from here.

The primary reason any of us invest is to grow what we have been able to save, faster than inflation eats it away. This is not easy. There are not a lot of things which grow faster than inflation. The things that do grow quicker than inflation have cycles associated with them. Usually they increase in value over time, but sometimes they temporarily fall. It is only because they can fall that they are able to grow faster than inflation. This falling part is what academics refer to as "risk", which is that feeling we all have right now.

Unexpected things happen. They just do. Using history as a guide, here are three things to think about as it relates to our current situation.

One: What has happened?

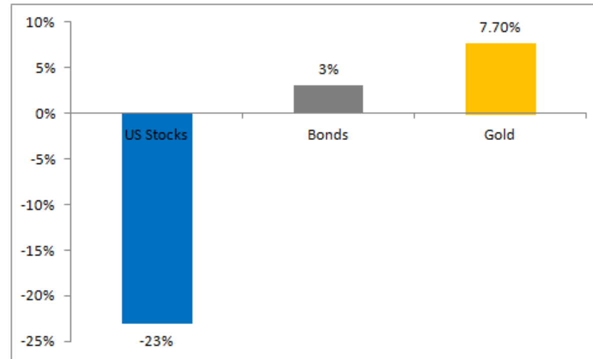
It is important to put current markets in context. The current expansion began in 2009 and since then a balanced portfolio has risen 128% (source: Morningstar Balanced, a standard benchmark). That represents a 7.7% annual return. Yes, the current market has given back some of that gain. It feels scary, but it hasn't taken back most of the gains we have enjoyed over the years. Ultimately, I believe the current crisis will be temporary. Markets will likely remain volatile in the near term but will recover.

Two: Stay diversified.

We have been here before. I began my investment career during the dot-com crisis in the early 2000's which imprinted on me the way I think about risk. Since 2000, we have experienced 6 declines of similar size to the current one. The result of this experience has been a staunch commitment to diversification, and an insistence on holding a portion of investments which are boring and at times seem to offer little upside. It is for times like this we hold them. Over the past few years, we have increased our exposure to these boring investments, which now make up approximately 50% of our clients' accounts.

The chart below shows the returns since the beginning of the year. The 'boring' investments (bonds and gold) which tempered our returns during the rising phase have once again proven their worth during the current period.

Year to date performance through March 12, 2020 (Stocks vs bonds vs gold)



We can't simply own the investments which make us feel good on the upside or the downside. There must always be investments in the portfolio that make us uncomfortable. They are there to help in case the markets don't go the way we expect.

Three: Stay invested.

The terrific returns of the past decade have also been generated with exceedingly low volatility. On average, the stock market should experience a temporary 13% loss each and every year. We have not endured such volatility recently which makes the current bout so jarring.

So, what is the most likely outcome of what we are currently experiencing? While no one knows the timing of the recovery, if we believe this is temporary (which I do), then we should look to history as a general guide. Below is a chart showing the US markets' largest declines and the subsequent 12-month recovery.

US stock markets' largest declines	Black Monday *Aug 87 to Dec 87*	Gulf War *Jul 90 to Oct 90*	Asian Monetary Crisis *Jul 98 to Aug 98*	Tech Bubble *Mar 00 to Oct 02*	Financial Crisis *Oct 07 to Mar 09*	US Credit Downgrade *Mar 11 to Oct 11*	Trade War *Oct 18 to Dec 18*
US stocks decline	-34%	-20%	-20%	-49%	-57%	-19%	-20%
Next 12 months	+21%	+29%	+38%	+34%	+69%	+32%	+37%

Risk is supposed to make us uncomfortable, but it's also where the inflation beating returns come from. When it works against our investments, it can be abrupt and scary. Lasting wealth is built on being disciplined with our investments.

As a final reminder, I am personally invested in the same investments as you are. So are my parents and I have to see them every week.

I am here to help. Please contact me if you have any questions or concerns.

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