Personal Financial Strategies in the Midst of the COVID-19 Crisis

10 ACTIONS YOU SHOULD TAKE NOW

Springwater
WEALTH MANAGEMENT

1 Limit your exposure to financial media

As investors, we're inundated 24/7 with "entertainment disguised as investment advice". We see it and hear it from what we think are credible sources, like magazines, newsletters, and websites, plus what is purported to be financial news on television.

Weston Wellington, Vice President at Dimensional Fund Advisors, refers to this, somewhat bluntly, as "investment pornography". Wellington is referring to the efforts of the print and online media to add emotion to short-term fluctuations in the market, and to create the perception that if we don't act on a particular event or "tip", our long-term financial well-being will be adversely impacted.

For example, on August 13, 1979, the headline on the cover of Business Week magazine was "The Death of Equities: How Inflation Is Destroying the Stock Market." Three years after that article appeared, the stock market hit bottom and then began a remarkable rise. By 2019, on the fortieth anniversary of the provocative headline, the total return on the S&P 500 stock index since its 1982 low was nearly 7,000%.

You should recognize that the media's primary driver is capturing "eyeballs". The more eyeballs they capture the more they can charge advertisers. In the 1970s, before the creation of the internet, this was measured by sales of magazines and newspapers (circulation). Today, the measuring stick is online "clicks". That's why it seems that every day there is yet another list of "7 Funds You Should Buy Now", or "10 Hot Stocks to Get Rich". The fact that stock-picking and market-timing don't produce better investment results is beside the point.

There's not a lot of information that can be gleaned from a market that is gyrating so wildly in the short-term. Investors are trying collectively to determine the "right" prices for stocks, in an environment where the short-term outlook for economic growth and corporate profits are very uncertain.

So, try to limit the amount of "investment entertainment" you consume – there's little or no benefit to be gained from it for you. If you're anxious, call your financial advisor. If you don't have one, consider hiring one. But do your homework first. If you like investing and want to learn more, here's a list of resources you can start with.

2 Look back at history for perspective

During every major stock market correction, a large portion of the financial industry's experts are convinced that "this time it's different". This was the case during the 2000-02 "dot com" crash and during the 2007-09 Great Recession. Yet today, tech companies are an ever-more integral part of our lives, and the financial institutions whose recklessness nearly destroyed the global economy are larger than ever.

A stock market crash occurs when a market index drops severely in a short period of trading. The US stock indexes we're all familiar with are the Dow Jones Industrial Average, the Standard & Poor's 500, and the NASDAQ.

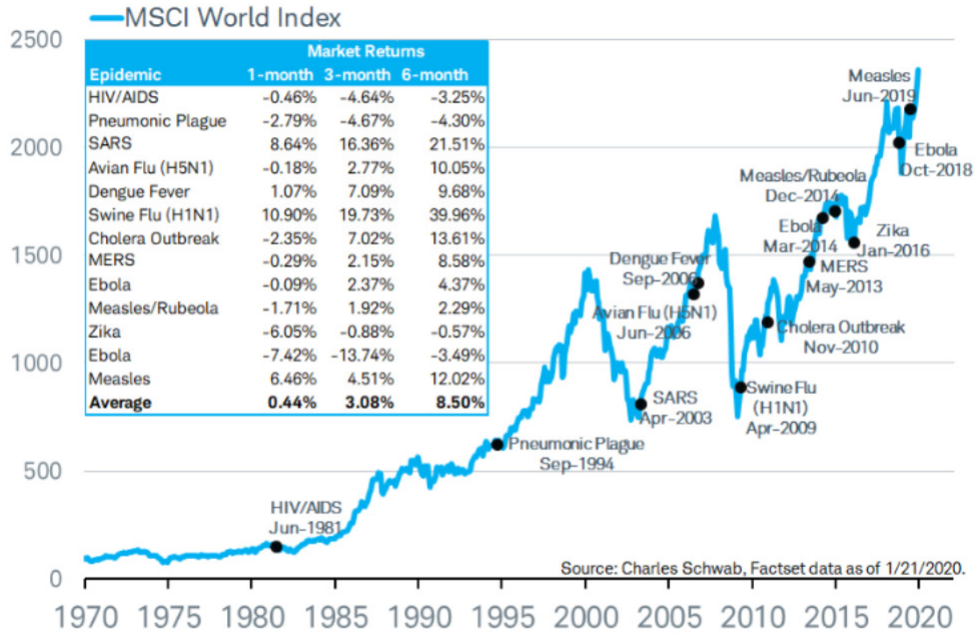
Market crashes are caused by nervous or panicked sellers. They may be afraid to see their stock investments drop in value, they may need to raise cash to meet obligations, or they may be reacting emotionally to an unexpected event, like a viral outbreak, natural disaster, or other crisis.

What should an astute investor do? During a market correction or crash, don't give in to the temptation to sell. Most panicked individual investors end up selling at rock-bottom prices, hampering their ability to save for long-term goals like retirement.

Instead, keep things in perspective. The stock market usually makes up most of the losses in the first few weeks and months following the crash. When the market rebounds, most sellers are afraid to buy again. As a result, they lock in their losses. If you sell during a crash, you'll almost certainly not buy in time to benefit from a sharp rise in prices.

The chart below shows 50 years of stock market history, and the many health crises that have occurred during this period. You can see that while the market periodically undergoes quite violent corrections – none of which were attributed to the health crises, the long-term direction is upward – which shows that investors get rewarded for taking investment risk. this has to be true or no rational person would invest in the stock market. All of their money would be in bonds, real estate, and other asset classes.

Immune: world epidemics and global stock market performance



Epidemic	Market Returns 1-month	3-month	6-month
HIV/AIDS	-0.46%	-4.64%	-3.25%
Pneumonic Plague	-2.79%	-4.67%	-4.30%
SARS	8.64%	16.36%	21.51%
Avian Flu (H5N1)	-0.18%	2.77%	10.05%
Dengue Fever	1.07%	7.09%	9.68%
Swine Flu (H1N1)	10.90%	19.73%	39.96%
Cholera Outbreak	-2.35%	7.02%	13.61%
MERS	-0.29%	2.15%	8.58%
Ebola	-0.09%	2.37%	4.37%
Measles/Rubeola	-1.71%	1.92%	2.29%
Zika	-6.05%	-0.88%	-0.57%
Ebola	-7.42%	-13.74%	-3.49%
Measles	6.46%	4.51%	12.02%
Average	**0.44%**	**3.08%**	**8.50%**

The MSCI World Index captures large and mid cap representation across 23 Developed Markets countries. With 1,646 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country. **Past performance is no guarantee of future results.**

3 Be patient, as this, too, will pass

The dictionary defines patience as "The capacity to accept or tolerate delay, trouble, or suffering without getting angry or upset". The 18th century philosopher Jean-Jacques Rousseau once said, "Patience is bitter, but its fruit is sweet." Successful investing requires a tremendous amount of patience over longer periods of time.

In the short-term, the stock market can be extremely volatile, and trying to discern a trend can seem like driving in a fogbank. Back in the 1920s, a reporter asked American industrialist John D. Rockefeller what he expected the market to do in the short-term. His response? It will fluctuate. Indeed it will. But over the long-term, capitalism works and investors are rewarded for taking investment risk. In fact, there is a name for this phenomenon – it is called Capital Market Theory.

During periods of market volatility, individuals often become increasingly uncomfortable, and many involuntarily shift their focus from long-term goals to short-term anxiety. It may seem rational to take some type of immediate, decisive action, if only to do "something". Unfortunately, quick investing decisions that are based on emotion often don't end well.

A major reason for this is what is referred to by psychologists as “recency bias”. Recency bias is the tendency to believe that trends and patterns of the recent past will continue in the future. So, if the market is trending downward, there is an inherent bias to expect this to continue. If the trend continues long enough, even disciplined, experienced investors may become skeptical and lose patience.

Is there a better way to respond?

George Meade, the US Army officer who defeated Confederate General Robert E. Lee at the Battle of Gettysburg during the American Civil War, once said, “Never fear your enemies, fear your actions”.

So, when the markets are volatile, and especially when they enter into one of their periodic major declines, taking your finger off the “sell trigger” is often the best course of action.

4 Talk to your advisors

A good financial advisor can help you reach your goals in a variety of ways. They can build a robust, personalized financial plan for you, that reflects all of your unique goals and objectives, and then maintain your plan over time, so that it always reflects current circumstances. For most people, annual updates are fine, but you should update your plan whenever there's a change in the broad economic environment – like tax rates, inflation, investment returns – or in your personal financial circumstances – like getting married, receiving a job promotion, moving, or retiring.

Your advisor can also design an investment strategy that's integrated with your plan, and that won't require you to take any more investment risk than is necessary. The investment strategy should include a recommended asset allocation (the "mix" of investments, including stocks, bonds, real estate and cash), so that you capture the benefits of diversification. Your strategy should take into account the benefits of asset location, as well. And, if you've asked your advisor to manage some or all of your investment and retirement accounts, they should periodically rebalance your portfolio in a disciplined, systematic way.

Normally, holistic planning and investment advice may well be enough to keep you making steady progress toward your goals. But, in tumultuous times the most important service your advisor can provide is behavioral coaching. When the markets are falling precipitously, your advisor should persuade you to stick with your asset allocation, and when it's rising rapidly, they should keep you from plowing more money into stocks when they've hit all-time highs.

If you're feeling anxious or unsure about your plan, your investments, or your financial future, reach out to your financial advisor, accountant or other trusted professional. They'll be able to listen to your fears and concerns, and provide you with the information you need to make smart, disciplined choices and stay on course.

Of course, you should make sure you're working with an advisor, and not just a transaction-oriented broker. You can use the CFP Board or NAPFA websites to find a fiduciary advisor who will be obligated to work in your best interest.

5 Review your plan and confirm that you're still on track

It's obvious that a higher return on your investments is better than a lower one. Unfortunately, there's really no free lunch in investing, and so when you change your investment mix with the expectation of generating higher returns, you also have to take on more investment risk. Here, we are defining risk as the variability of your portfolio's returns over time. So, investing for more return means accepting a higher level of future volatility in those returns.

Research has shown that investors tend to have "asymmetrical" tolerance for investment risk. That just means that we find losses more painful than we find gains enjoyable. So, increasing the riskiness of your investments to generate more return isn't as easy as it sounds, and that's why so many individual investors panic and sell stocks at rock-bottom prices during a market correction or bear market.

We've been working with investors like you for decades, and in our experience there's a group of people who tend to weather these periodic stock market storms better than others. They're those with a robust financial plan. Why?

When you're able to look at your portfolio not in isolation, but instead as the engine that drives your financial plan, you can view the stock market's volatility in context. You recognize that short-term bumps in the road (i.e. volatility) are the price you have to pay for long-term growth. And you realize that you shouldn't take any more investment risk than is necessary to achieve your goals.

A good financial advisor will use sophisticated planning software that will make it very easy to regularly update your plan, so that you can see that you're still on track to achieving your goals. Another benefit of regular plan updates? To use a sailing analogy, you'll know when you're getting off-track, giving you the opportunity to make small course corrections on your journey, and maximizing the likelihood that you'll arrive safely at your destination.

6 Avoid selling distressed investments

If you have been brave enough to look at your portfolio the past few weeks, you have probably been sobered by the declines in almost all the individual securities that you own. This stock market sell-off, which has a biological and not economic origin, has been unique in that some investors have run in panic from every asset class.

In most crises, risky asset classes, such as common stocks, have been sold at much lower prices. In particularly bad crises, if there are credit concerns, we might even see some investors sell higher quality US corporate bonds. But it is highly unusual to see investors sell asset classes that have historically been safe-havens. These asset classes include municipal bonds, US government securities, gold and other precious metals. But that's exactly what happened. Cash is safe and some investors have sold everything to stockpile cash that produces close to zero net return, but does not decline in value.

What should you do? Do not follow the crowd heading for the exits. Investors who cash in investments that have experienced near-term losses have effectively locked in or "realized" those losses. What was once a temporary paper loss on an investment statement is now real loss. You can avoid this.

Instead of selling rashly, step back and consider your situation. What has changed since the beginning of the year? Yes, there is a global pandemic and it has resulted in a major stock market sell-off. But have your circumstances changed? Maybe if you work in an industry that has had a lot of lay-offs. Maybe not if you are already retired.

You should be reviewing your current investment plan. Hopefully, it includes an "investment policy statement" (IPS). If you don't have an IPS, now is a good time to develop one. Have your investment objectives changed? Has your time horizon changed? What about your tolerance for risk, your ability to take risk, your need to take risk and your willingness to do so? What is your target asset allocation? Is your portfolio diversified across and within the asset classes you wish to own? Are you managing the expenses associated with your portfolio? What is your performance objective over longer time periods?

Once you focus on your investment plan, it will become clear what needs to be done in the face of this most recent market decline. The most likely effect of the market drop is that your desired asset allocation is very likely different than your current asset allocation. So, you should take action to rebalance your portfolio. It is entirely possible that you will end up buying, not selling, distressed asset classes.

7 Rebalance your portfolio back to the desired asset allocation

Let's assume that before the coronavirus crisis you had thoughtfully crafted your target asset allocation across major, and perhaps minor, asset classes. Remember that an asset class is simply a group of securities that have common characteristics (e.g. risk, return, tax treatment). Major asset classes include stocks, bonds, real estate, commodities, alternatives, and cash equivalents. Examples of minor asset classes would include US small cap value stocks, emerging market government bonds and international large cap growth stocks.

Given the massive gyrations caused by the COVID-19 outbreak, your actual asset allocation is now undoubtedly rather different than the target. This might be disturbing, but it is not surprising. What do you do?

You rebalance your portfolio back to your target. Let's consider a simple example. Let's say that your target portfolio was 50% in stocks and 50% in bonds and cash. We will further assume that the stock portion of your portfolio was divided equally between US and international (i.e. non-US) stocks and that you had 45% in bonds and 5% in cash and cash equivalents. You started out with $1 million with that allocation. So, you had $250,000 in US stocks, $250,000 in international stocks, $450,000 in bonds and $50,000 in cash and cash equivalents.

Along comes the coronavirus. We will assume that US stocks drop by 30%, international stocks dropped by 25% and bonds sink by 5% and cash and cash equivalents remain static (i.e. 0% return). That means that your US stocks are now worth $175,000, your international stocks are worth $187,500, your bonds are worth $427,500 and cash and equivalents is still worth $50,000. So, your portfolio is now worth $840,000 and you're down 16%. It could be worse, right? Your asset allocation has sheltered you from the brunt of the damage.

But you need to rebalance and doing so offers a few distinct benefits. You will be selling asset classes that are over-weighted and buying asset classes that are under-weighted. Consequently, you will be buying asset classes that are essentially "on sale" compared to where they were just a few weeks ago. Savvy investors like sales prices. You may also be able to realize losses for tax purposes, if some or all of your investments are in a taxable account.

To rebalance, we first need to figure out your new asset allocation. Simple math tells us that your new asset allocation looks like this: US stocks = 21%; international stocks = 22%; bonds = 51% and cash = 6%. How do you move back to the target allocations? Again, with basic math, we calculate that you need to sell $49,500 of your bonds and use the proceeds plus $8,000 of your cash to buy $35,000 of US stocks and $22,500 of international stocks. Once you do that, your portfolio will once again look like your target.

8 Harvest losses to capture tax benefits

Just as the coronavirus crisis has swept through the human population, it has torn through investor portfolios. The volatility has been significant, plunging the stock market into a "bear market" after a historically long "bull market." As of this writing in late March 2020, US stocks are down 25% from the peak in early February and down 20% from the start of the year. International stocks are off 22% since the peak in mid-February and 17% from the beginning of the year.

Investors do not like losses. But they can present an opportunity. If you have suffered losses in the taxable portion of your portfolio, you can turn them into a tax benefit. Taxable losses can be used against taxable gains, they can be used as a deduction up to $3,000 against ordinary income, and unused taxable losses can be carried forward for future use.

How does tax loss harvesting work? First, this strategy only applies to taxable accounts. You cannot harvest losses in retirement accounts or other tax-advantaged vehicles like annuities.

Also, let's make a distinction between a "paper" or "unrealized" losses and a "realized" loss. An unrealized loss exists when an investment you own has declined in value below what you paid for it, but you have not sold it. A realized loss occurs when you sell an investment that has a current value that is less than what you paid for it. The difference between the price you paid when you bought the investment and the price you received when you sold it is your loss. By the way, the same treatment exists for gains except that you are selling an investment for a price that is greater than the price you paid for it.

Losses (and gains) can be either short term or long term. A short-term loss is a loss that occurs on an investment that you have owned for less than a year. A long-term loss is a loss that occurs on an investment that you have owned for more than a year.

How does the tax treatment work? Short term realized losses are offset against short term realized gains. Long term realized losses are offset again long term realized gains. Net short term gains/losses are then offset against long term gains/losses.

Now, how do you actually harvest losses? You start by reviewing the current values in your taxable account(s). Do not rely on monthly account statements to determine the gains/losses in your account. Instead log into your custodian's client/investor website to obtain current values. Most custodians provide cost basis information on a separate page for investors. Go to that page and look for those positions that are red (i.e. have lost value since you bought them) and note which of the losses are short term vs. long term. Do this same exercise for those positions that have gains.

Now you have to decide if you want to realize the losses by selling those positions. Does it make sense to realize gains as well? Perhaps, if it will allow you to rebalance your portfolio at the same time. So, consider tax loss harvesting in conjunction with portfolio rebalancing.

Remember to always seek the advice of a tax professional when making decisions that will impact your tax status.

9 Keep extra cash on hand

The banking system has been reporting that cash withdrawal activity at ATMs and local branches has been markedly up since the coronavirus became a global pandemic. That is a sure sign that many people are very anxious about the future and the security of their money, so much so that they are storing currency in safety deposit boxes at their local bank and in safes at home … and perhaps under their mattresses or in cookie jars.

We recommend that you have plenty of cash on hand. But we do not mean that in the literal sense. The world really does not run on cash anymore and very few businesses do not accept credit cards. Also, the banks, credit unions, savings and loan associations (aka thrift institutions) in the US are healthy. This is not the Depression during which banks failed, the savings and loan crisis of the 1980s or the subprime mortgage crisis of the Great Recession. In fact, US financial institutions are strong, properly-capitalized and well-regulated. There is no reason to pull large sums of cash from financial institutions and store it at home.

But it does make sense to have cash in your bank or brokerage account. Why? We all need to pay our bills and we pay them with cash, of course. The grocery store, the water utility, the restaurant (take out only) and the gas station (among the many places where you spend money) will not accept gold coins, stock certificates, bitcoin, etc. They want cash and you can pay with hard currency, credit card, checks, ACH (automatic clearing house) and/or EFT (electronic funds transfer) transfer, depending on the vendor. You should always have enough cash in your accounts, so that you do not need to sell investments that may have lost value during the coronavirus market slide. How much cash to keep for spending is a function of your spending needs and your income sources. If you are living on investments alone and taking occasional distributions from them, you should have at least enough cash to pay for expenses for 12 months.

It's also good to have extra cash to take advantage of buying opportunities that pop up. Right now, stocks have been discounted by about 25% from just a few weeks ago. If you have extra cash, consider buying some distressed investments that have the potential to recover their value once this pandemic ends. Just make sure you do this across broad asset classes which will give you diversification and not by buying individual stocks which won't. Astute investors love sales and the deeper the discount the better.

10 Avoid stock picking

It is very tempting, in the midst of an economic crisis and massive stock market decline, to think that you can identify stocks that have been oversold. But the price of any publicly traded security reflects the consensus view of the value of that stock. If you believe a stock is mispriced, you are running against the "wisdom of the crowd." That theory holds that the overall market properly prices securities accurately.

Need proof that stock picking is foolish? Consider the track record of mutual fund managers. The vast majority of fund managers fail to beat the performance of the benchmark against which they compare their efforts. This is true for all asset classes and for long periods of time. Yes, there are fund managers who beat their benchmark or the overall market. Yes, there have been some managers who have outperformed for several years running. But broad market research does not allow us to discern whether such performance was a function of unique manager skill or simply luck.

Here's another way to think about this. Imagine filling the University of Michigan's football stadium with 100,000 mutual fund managers. As they enter the stadium, we give them each a quarter, a piece of paper and a pencil. We then ask them to flip the quarter 100 times and record the results. What would we expect? The law of averages indicates that we should find that, on average, the fund managers end up with 50 heads and 50 tails. Does that mean that every manager will record this result? No. Some will have more heads and some will have more tails. Can we say that those with more heads are better at flipping for heads than their peers? No. The same is true for those who end up with more tails. We should be able to graph the results and expect to have a "normal" (i.e. bell shaped) distribution of results. There will be some who flip for more heads and some who flip for more tails. This illustration is pretty consistent with the performance that we see with mutual fund managers.

Remember mutual fund managers are bright, highly educated, well-credentialed and experienced investment professionals. They are managing a fund, because they are perceived by the industry as having the ability to manage a fund in a manner that will result in benchmark or market-beating performance. They are backed by significant resources in the form of research analysts, technology and spending power which the typical investor simply does not have.

So, avoid stock picking. Build your portfolio across asset classes using passively managed mutual funds and exchange traded funds. You won't beat the market. But you will earn the return of the market and, as it turns out, very few mutual fund managers seem to accomplish that.

About Springwater Wealth Management

At Springwater, we're committed to putting our clients first. As fee-only, independent, fiduciary advisors, our only priority is you. While we work with a diverse group of clients, our specialty is helping independent women, young professionals, and (pre)retirees. Our goal is to help you provide for your lifestyle while supporting the people and causes you love. We can guide you through the steps to accumulating wealth while managing the risks to your financial future and minimizing taxes.

To learn more about how we can help you build a plan for your financial future, you can schedule a free introductory consultation online or by giving us a call. There's no obligation. This is just an opportunity for you to hear how we can help and decide if we're the right financial advisors for you. We hope to hear from you soon!

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