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Meritas' Observations Regarding Recent Stock Market Declines

In December 2018 we received a number of calls from clients recently regarding the current market declines. Experience tells us that other clients are also thinking about it, but not calling, so we wanted to share our thoughts with you in the e-mail below.

Main Points

- Current economic conditions are healthy
- Market predictions are reliably unreliable
- The best way to reduce portfolio volatility is to look at it much less often
- Nothing about the current market conditions gives us reason to change our investment strategy
- We will be doing Tax Loss Harvesting in some portfolios

Current Economic Conditions are Healthy (for the most part)

The recent drop in the US and Global stocks has been difficult and frustrating in and of itself. It's especially hard to justify the decline when one looks at the economic fundamentals:

- The economy is growing by about 3%, with a robust labor market and rising wages.
- Inflation data last week looked exceptionally tame, below the Federal Reserve's targets.
- The Fed plans to slow interest rate increases in 2019 causing Treasury rates to remain steady.
- Both the U.S. and China need a trade deal and they're making progress behind-the-scenes.
- A government shutdown is possible but will have virtually no impact on the markets.

So – why are the markets so volatile? There's a fear of weaker economic growth virtually everywhere in the world. However, low interest rates, modest inflation, solid economic growth, decent corporate profits, plus an eventual trade deal looks good to us! Of course, the economy isn't as red-hot as it was nine months ago, but the key is sustainability – and this economy can grow at a respectable, albeit less exciting, 2-1/2 percent.

Market Predictions Are Reliably Unreliable

While there is no shortage of people making predictions, the truth is that none of us can accurately predict the movements of the markets. If we could, then we would always make trades ahead of market moves, and it wouldn't take long before that amazing crystal ball would have generated billions of dollars from stock market trades. Unfortunately, crystal balls are rarely accurate.

There are many people who claim to know where the market is headed and they receive ample press coverage because it makes great headlines. It doesn't matter that the prognosticators have a poor record of success or that the predictions seldom come anywhere near true.

A recent article by frequent blogger Barry Ritholtz offers some rather amazing data on people who are in the prediction business. For example radio personality Peter Schiff has been telling listeners since 2010 that the price of gold is heading toward $5,000 an ounce (It's riding around $1,200 currently). Jim Rickards, former general counsel at Long-Term Capital Management, is more ambitious, telling his followers that he has a $10,000 price target for an ounce of gold. And if you happen to follow former White House Budget Director David Stockman, you have been told that stocks are going to crash in 2012, 2013, 2014, 2015, 2016, 2017, 2018 and 2019. Someday he's going to be right, and will no doubt be touting his amazing prediction abilities.

The Best Way to Lower Volatility

All investors would love to lower the volatility of their investment portfolio and still have high long-term returns, and there is a simple solution. It is not retreating to cash. Even in times of low inflation, sitting in cash is a strategy doomed to steadily lose the buying power of your portfolio. All that does is guarantee a downside.

Diversification will only get you so far in the short-term. Downside risk doesn't go away completely just because you're holding multiple asset classes, as everyone learned all over again in 2008-2009.

The actual answer is: look at your portfolio less often. Volatility is actually a time-based concept. Your portfolio goes up or down literally several times a second during every day, and of course you would go crazy if you watched it second-by-second. So maybe instead you check it daily. But why daily? Why not monthly? You know it's a bad idea to sell out when the markets go down, why tempt fate and look even that often?

A recent report looked at monthly historical returns data for four combinations of global stocks and bonds going all the way back to January of 1926, up until December 2017: 30%/70%, 50%/50%, 70%/30% and 100%/0%. The portfolios were rebalanced back to their original asset mixes every year, and 1% a year in management fees was taken out of total returns. The result shows what kind of volatility you would have experienced if you had looked at your portfolio once a month, once a year, once every five years or once every ten years.

Across all four portfolios, if you looked at all of them once a month you would see a negative return about once every three months. If you looked once a year, you would only see a negative return about every 6 years. And if you only looked once every 5 years, about 90% of the time you'd see a positive return. That is, 9 out of ten times, your portfolio's value would have been higher than the last time you checked. And if you only looked once every ten years, pretty much every time and for all the portfolios, you would see a positive return.

That said, we aren't encouraging you to go years without looking at your portfolio. This is, however, why we continue to support our long-term approach to global diversification with disciplined rebalancing. **There is nothing about this current market that causes us to consider a change in our strategy.**

Potential Tax Loss Harvesting

You may see some increased activity at year-end as we take advantage of the downturn and harvest capital losses in your taxable portfolio. This is known as Tax Loss Harvesting and allows you to use these losses to offset current capital gains or to store the losses to offset future capital gains. In most cases, it defers tax liability by a year or two. Typically, we will sell the new holdings and go back to your original investments after 30 days (IRS requirement).