Stress-Adjusted Returns - Transcript

Tom: Welcome to the Mullooly Asset Management Podcast. This is episode number 300. Thanks for tuning in. So we've got Tim, Brendan, and Tom Mullooly here to talk about what's going on today. We're recording this on Thursday, March 26th, 2020. Brendan, you put some numbers together about a nightmare scenario. Do you want to kind of walk through what you've come up with?

Brendan: Yeah, I think something that people worry about a lot is obviously a big downturn in the stock market, but especially one where maybe you were on the precipice of retirement or beginning to draw on your accounts. I just put together some numbers using the last big downturn in 2008, 2009, as kind of like a blueprint to illustrate how somebody with a portfolio of stocks and bonds that they needed to rely upon might have fared. So I looked at hypothetically somebody who retired in August of 2008, and then in September they wanted to start taking a check from their account. And September 15th, 2008, was the day that Lehman Brothers went under. We just assume in that stretch there that they put together a mix of investments, assuming that they were going to need distributions from their account and from September of 2008, through March of '09, the S&P 500 goes down 42%. so just use that as a proxy for the stock side of their account, like you're down 40% on your stock investments.

Tom: In the first six months.

Brendan: Right. Your timing couldn't have been worse, epically bad timing, right. The way that we put together portfolios and most responsible people do is that if somebody is relying on their money especially, you're never going to have them 100% exposed to the market with all of that because they're going to be taking distributions from their account. And so you'd have something along the lines of their next one to three years of expenses in a mix of cash and bonds. And so I ran numbers just using the S&P 500 as a proxy for stocks and the aggregate index AGG, as a proxy for bonds and just looked at stretches of time after this moment of Lehman collapsing in September of 2008.

Tom: Bring the ball forward now. If we're, say looking at this, say a year later, where are we at if the client totally lost their mind?

Brendan: So one year out bonds are up 6.7%. The S&P 500 is down 9.6%. What they've been surviving on, the bonds and the cash, is up somewhere in the realm of six or seven percent,. So more than what they started with. So gave them a little cushion to even take some money out. Even though we had already accounted for the fact that they were going to need all of it just to live off of on a month-to-month basis. And the stock side's down almost 10%.

Tom: So from down 42 to down 10.

Brendan: Not great, but a certainly not catastrophic. I mean if you build a portfolio that can't survive being down 10% on a one year basis, I don't know what you're doing.

Tim: I mean down 40% years don't happen all that often, but down 10% years, sure, in the normal realm of possibilities.

Brendan: Yeah and look, even down 40% years happen on average, like once every five to seven years, we see a bear market. And so you got to build a portfolio that can withstand this kind of stuff. That doesn't mean getting out at the top ahead of time. It just means that you're going to survive through this by relying on fixed income, stuff that's going to hold off to give the stocks the time they need to then recover and support the plan that you put together in the first place.

Tom: So I want to just hit the pause button here for a second because what we're talking about is a portfolio where we're not making changes, not going all in or all out.

Brendan: Absolutely not. We're not doing anything. In fact, just to continue down the trail here, two years out from the collapse of Lehman, so the fall of 2010, the bond side of the portfolio has put up 14.9% since that point in time, so 15%. And the S&P 500 is down 1.4%. So basically flat two years out.

Tom: But you've made back. You've gone from a minus 42 at one point to back to zero.

Brendan: Right. And your income hasn't been compromised in the interim. In fact, you've made a little on the bond side of the portfolio.

Tom: Are we getting dividends on top of that?

Brendan: This is total return. Three years out, the aggregate bond index is up 21% and the S&P 500 is now positive. You're up 7.9%.

Tom: So you've made a couple of percentage points on the stock side, about two to two and a half percent a year, annualized. But you've made about 7% a year on the bond side.

Brendan: Right.

Tom: Now, just a quick question for some who are listening, they're like, how can that be possible if bonds are yielding 2%? how do you make 7% in your bonds?

Brendan: Well, as yields go down and Fed lowers rates during a crisis and people buy into safe haven assets, like a bond, you're going to get some capital appreciation too. These are just straight returns from the ETFs too. The blend of the two, I'm sure you would've been rebalancing at some point over this period of time too. So that 21% you gained in the bond piece of your portfolio, not only supported income that you needed, but you could have used chunks of it to buy some stocks while they were along the road to recovery that they took over that period of time.

This is where it gets pretty interesting though. Five years out from the collapse of Lehman, the aggregate bond index is up 23 and a half percent. It's still pretty good returns from bonds over a five year period. But the S&P 500 at that point was up 58%. That's pretty good. This is the counterintuitive part, is you think that you have really bad luck because you timed everything super poorly and Lehman collapses. And if you can hang in there for five years, and if somebody told you that the onset of a five year period that you were going to compound at 10% per year annualized, you'd probably say, all right, sounds good. But you forgot the part where the first year of that includes a 42% draw down and negative 10% and you're still negative two years out. And you just need to hang in there because you get all of that in years three, four, five.

Tom: We throw around a lot of numbers when we're talking about this kind of stuff, but to just put it in dollar terms, if you had a portfolio that was 70/30 and your 70% side was $1 million, in the first month or two, you're looking at something that's now $580,000. I mean it looks like half of your money is gone. And I know that folks who are listening to this have been logging into their accounts, looking at similar numbers. So we want to run through this exercise for a reason. It's going to be all right.

Brendan: It gets even more all right when we get to 10 years out because 10 years out, so this is the fall of 2018, if you put your money in at the top before Lehman collapsed and then sat tight, the aggregate bond index up 39%, S&P 500 up 196.5%. so you almost doubled your money with baking in the fact that you had one of the worst starting points in recent history.

Tom: That's pretty stunning to see. So you averaged about 4% over 10 years in bonds, more or less. But your returns from the stock market, starting with a minus 42% whole, worked out to be 19 plus percent on an annualized basis for 10 years.

Brendan: Right.

Tim: And when we're making financial plans for people, you make assumptions on what you can reasonably expect annualized from stocks and what do we usually use for annualized returns, like 5%, 6% something like that.

Brendan: Playing cautiously.

Tim: Right.

Brendan: But it's within the realm of possibility to get returns like this. But it's certainly not if just like point along the way you try to pull the plug because you're freaked out. And I'm not saying it's not to be freaked out when you, like what Tom just said, you start with 1 million bucks on the stock side of your portfolio and you see it at 580,000 at the trough in 2009 in March. Yeah, that's really scary. But I don't know. You put together a plan based upon when you need the money and what you're going to need from it and you stick to that. And if you do it, you can get returns like this because even with really bad timing, if you give the stock market the time that it needs, we have no reason to believe and no historical evidence to provide any context that would say that we shouldn't trust it.

Tom: In 1987, when the stock market went down 22% in one day, one day, we started hearing from market strategists who were saying, the early part of the 80s were really good. We were making 16, 18% a year in stocks. I think the expected forward returns have to be a lot lower going forward from stocks because the historical average for stocks that at the time was like 10% going back to the 1920s. So they're like, we've made too much in periods prior to the crash, so our expected forward returns should be a lot lower. Want to just address that?

Brendan: I mean if somebody had said that before Lehman collapsed, they weren't wrong on like an intermediate term basis were they?

Tom: Not really.

Brendan: On a three year basis, the returns from stocks sucked.

Tom: Yep.

Brendan: Three years out. But if you give it enough time, I think that when people talk about valuations and lower expected returns, they're talking over an intermediate term time horizon, which may or may not be important to your financial plan. The intermediate term time horizon is going to be a blend of stocks and bonds anyway. And so the part of your portfolio that's going to have the longest time horizon and be 100% stocks subject to expected returns like that has a horizon much longer than anybody would say valuations matter over. I mean valuations matter over the intermediate term. I think over the longterm you just converge on the historical averages, but that's talking 10, 15, 20 years plus and people don't really care about that when they're in the moment. And so people refer to different numbers with that.

Tim: I think it's really important too, for what we're talking about, to make sure that when you set up your financial plan to actually think about when you're realistically going to need the money. It would make it a lot easier to stick with a plan knowing that you're not going to need this money for 10, 15 years. But if you go into it and you don't really know when you're going to need this money, you don't really think about it, then it might come a day where it's like, oh crap, I need this money like next year, but we're in the middle of a 30, 40% draw down. Now what do I do? I didn't think about that. So taking the initial planning process seriously and really considering when you're going to need the money will definitely help you stick to it in the long run.

Brendan: I don't know how you could manage the portfolio at all if you don't have any context for when you're going to need the money. If you have no context at all, you might as well just watch CNBC and day trade your account all day because you're just gambling. There's no plan, there's no purpose for the money. How could you possibly formulate a sensible investment mix with no context whatsoever? It's not possible.

Tom: Okay. So we all saw three charts that were put out by Ed Yardeni, regarding the forward PEs. We don't spend a lot of time talking about PE ratios, but it's really a point that we should spend a minute talking about when it comes to valuations.

Brendan: Valuations do matter whether they're your book or not and you want to talk them because the counterintuitive point here is that when we see the price to earnings ratio is the price to the earnings ratio. And so when the prices drop as sharply as they have, these ratios reach points where expected returns look really good. And so it's interesting because the initial instinct when we see 30% drops in the stock market is like, oh crap, I got to get out of the way. But in reality, these prices going down just means that on a move forward basis you should be expecting some pretty good returns. But you're getting them by accepting the risk and uncertainty and scariness that come with putting money to work right now.

Tim: Right.

Tom: So we had expected forward returns or PEs for the S&P 500 in 1999, when tech stocks were really taking off. Most of these were trading in the high thirties. NASDAQ was trading at over 40 times earnings.

Brendan: And so to your point, just again to why this is counterintuitive. At that point in time, you didn't have to do any convincing. People were throwing money hand over fist into the stock market because they thought it was a great idea when in reality forward returns on a move forward basis from that point, were lackluster and these ratios were correct. They were bad for the intermediate term. It was not a great time to be putting money into stocks.

Tim: Yeah, people always say like, well, these ratios are too high. Let's wait for them to come down a little bit and then that'll be a better point to invest. But when they actually do come down, it doesn't feel good to invest at that time because something like what we're going through right now is usually going on and companies are taking hits for different reasons.

Brendan: When these things are high, it feels good and everybody wants to buy stocks and now when they've sold off in returns, they're going to be better moving forward nobody wants to buy stocks. And you should try your best to either not react on either end of that spectrum or to do the opposite of what everybody is doing because that's probably going to be best for you in the long run.

Tom: Let's talk about not jumping in and jumping out of stocks. I know the market's up today as we're recording this. We've had a couple of actually strong days in a row now. I don't know if it's going to last because we're recording this at 11 o'clock in the morning, so who knows what four o'clock will bring? We've had a couple of good days.

Tim: Yeah, I mean if you sold, let's say, I mean Monday of this week was roughly the lows of what we've seen. It's been down about 35 36% for the S&P and the Dow. They're both roughly in that range. But the next two days, right after that, I mean we're up 11% on the Dow on Tuesday. Yesterday was another couple percent. So it just goes to show that if you sell out on huge down days like that the potential to miss a bounce back is usually right around the corner because we've seen studies that show usually the best and worst days tend to happen pretty close to one another. Not necessarily always back to back like that, but usually within quick succession and it's hard to jump out and jump back in.

Tom: Something else, just to kind of piggyback on what Tim said is that, I wake up and not right away, but I do look at the futures before I come into the office.

Brendan: It's okay if it's right away, you can be honest.

Tom: Okay. Okay. Okay. So I do look at the futures in the morning and I think what a lot of people miss is that the market's down a lot one day and you call your advisor or you call your broker or you login and you say, I want to make some changes in the account. If it's after the market has closed, you're not going to get those prices. And when the future's open, futures now end and then they begin trading, the market has already moved.

Brendan: Most of the moves, these last three, four weeks have been gap up, gap down. And especially, this works in either direction, if you sold out let's say on Monday and then saw Tuesday and we pretty much just gapped up.

Tom: Yeah, you missed it.

Brendan: Right. And so if you're trying to throw your money back in.

Tim: It's impossible.

Brendan: Right. And the same goes in reverse. If you are trying to buy back in at the right time, you could be buying back in after a huge update and then the next day could gap down again. And it's like, oh, do I still want to buy? And you don't have to play these games to earn good investment returns over the long term. In fact, I would go so far as to say that those games are counterproductive to you earning returns. It's just eroding the advantage that you have of hanging in there. Or if you must act doing something far more gradual than out or in, on or off, that's just, you're not going to win playing that game. You might get lucky a couple of times. Eventually you're going to blow yourself up and you're going to earn bond-like returns with all of the frustration of being in stocks.

Tom: I think the folks that are systematically putting money into their accounts, whether it's a retirement account at work or systematically investing in their brokerage account, their investment account, I think those are the folks that are really going to come out ahead because they're continually putting money in at all different kinds of levels.

Brendan: We talk about risk adjusted returns in the business. Let's call this something else. What about like stress adjusted returns? So people that are trying to make big decisions about should I go in with a lump sum of money or like should I take all of my money out? I think the people who just dollar cost average in on a set schedule and don't change it, whether the market's down 30% are off 30% on the year, have the best stress adjusted returns. And I think that there's something to be said about that because you need to be able to get the returns you need and not worry about it. Most people that are investing aren't checking the futures in the morning when they get up. They've got other stuff to do, that's not what they do with their lives. So they don't need or want the added stress of trying to make these huge all in all out decisions that can cost you large amounts of money based on basically randomness and luck in the short term. If you nailed it, I'm sorry to tell you, you got lucky. And if you didn't, you got unlucky. People are probably more receptive to that one than the other.

Tim: The example that you just laid out from Lehman to 10 years out is a perfect example of that. You didn't need to check any headlines or make any changes or have any stress, just leave it alone and you would have annualized 19%. It'll work out.

Tom: The problem though with that is that when there's terror and people are panicking and people are really nervous, they think they should be doing something when doing nothing is probably the right answer. When markets move like this, it's a stupid term I came up with way back, I call it upsettedness, where people just get upset seeing the losses in their accounts. And they see this erosion from day-to-day and week-to-week and they're like, shouldn't we be doing something? And so it's hard for people to envision 2025 or 2030. But this is what this money is for. It's not for 2020. That money's already set aside. It's not in the market. It's hard when you're sitting here in 2020 and the world is melting around you. Oh yeah, this is for money that's for three years, five years, 10 years and maybe longer.

Tim: Really hard.

Tom: Tim, we got some jobless claims this morning.

Tim: I think the highest number ever. It was almost 3.3 million initial jobless claims. Before we turned the microphone on, I posed the question if you told someone a couple of weeks ago that we would have initial jobless claims of three million plus, what do you think the market would do? And I feel like a lot of people would say sell off. But as of this recording, the opposite is true. So it just goes to show that a lot of these economic numbers, they don't necessarily predict what's going to happen in the stock market. Sometimes good news is good news and sometimes good news is bad news and vice versa.

Brendan: Yeah. If we had next week's numbers for jobless claims, I couldn't use that information to tell you whether the market will be higher or lower then.

Tim: Yeah. We could have lower numbers.

Brendan: We could have any economic data point, at any point in the future and it would tell you absolutely nothing about the direction the market's going to take in the interim. So anyone who is basing investments on data like that or at any single data point for that matter is predicting the future and they're fooling themselves if they think they're doing anything other than guessing.

Tom: Right.

Tim: Right. Agreed.

Tom: The other news overnight, this pandemic relief package went through the Senate, 96 ZIP. Now it's turned over to the house for a voice vote or unanimous consent or however they're going to get this thing through and then it looks like the president's going to sign this tomorrow. This is when now going forward, I am not going to tie this to the market, but there was a lot of anticipation that we're getting a deal, we're getting a deal, we're getting a deal. Now we have a deal. I think this is when the knives are going to come out. People are going to start tearing it apart and saying, we're doing too much for businesses, and not enough for individuals. Or we're not doing enough period. Or this is a giveaway, we're going to have trillions of debt now.

Brendan: Everybody on both sides of the aisle needs to stop.

Tom: Yeah, everyone is going to find something wrong with this deal. The same thing happened with TARP and all the other financial packages that they brought out in 2009. According to everyone, there was something wrong with all of these deals. Quit complaining. We have a deal. And I think that's really a relief. What I stressed on the video this week is the speed and the size of these deals. When you think about when the Fed actually got around to starting QE and when the Fed started lowering interest rates, they were way, way, way after the events that took place. And Congress getting their act together on some kind of relief package, the speed that they were able to get this done, it really is historic. This relief package, it's $2 trillion. I mean that is three times the size of what they did after 2008.

A lot of good stuff. I'm sure there's going to be a lot of problems and everybody is going to find something wrong with it. So what? Okay. Thanks for tuning in. Remember, if you've got questions, reach out to us, whether by phone or by email. We're ready to help answer your questions and talk about what's going on.

Thanks again for tuning in to episode number 300 of the Mullooly Asset Management Podcast.