LEWIS WEALTH MANAGEMENT

Newsletter

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Executive Summary

The world is in a hot mess right now, and we are on the precipice of a historic presidential election in a hyperpolarized political environment.

So, how can the stock market be rallying right now? Well, a massive amount of fiscal and monetary stimulus has been dumped into the economy. The stock market is betting on a recovery, and five technology stocks are leading the way (the rest are far behind). Wall Street is not experiencing the pain of Main Street right now.

There are risks ahead. Some recent job losses are becoming permanent. Medical experts are concerned about a second wave of the virus. State and local governments are suffering financially. The government has been unable to agree on a second round of stimulus.

If you are currently in a well-diversified portfolio invested in a good asset allocation filled with solid investments that match your risk profile and long-term goals, you might be smart to sit tight.

But if you feel like reducing risk in your portfolio, it is possible to do that in a measured and rational way (see inside).

In the end, sometimes you need the right amount of perspective, patience, and perseverance in order to prevail in the long run.

Lewis Wealth Management
(855) 353-3800
www.LewisWM.com

What a Hot Mess

Most of us can't wait for 2020 to be over. This has been one of the most difficult years in our lifetimes. We are suffering through a global pandemic that is threatening our physical and economic health and our cherished way of life. We are on the precipice of a historic presidential election in a hyperpolarized political environment.

We are all suffering from heightened anxiety and fatigue. Given everything we are dealing with, the most frequent question I get from clients is …

How Can the Stock Market Be Rallying Right Now?

There are several reasons.

First, a massive amount of fiscal and monetary stimulus has been pumped into the economy. Between the Federal Reserve and the coronavirus stimulus bill passed by Congress (the CARES Act), there has been a 25% increase in the money supply, and much of that money has found its way into the market.

Second, the stock market is always forward looking. It is looking past this recession and the pandemic. The market is betting on a recovery – and up to this point in modern market history, the market has always been right.

Third, there are five stocks leading this recovery: Microsoft, Apple, Amazon, Alphabet (Google), and Facebook. ***These companies have business models designed to thrive during the pandemic and recent lockdowns.*** Some investors have been aggressively buying these stocks, and they have become overvalued. A new class of young day traders who are working from home have made substantial bets on these five stocks and the options tied to them.

Anyway, these five stocks currently constitute 25% of the total market cap in the S&P 500, and they have been up about 33% this year while the other 495 stocks are down 2.5%. But things are starting to turn. Since September 1, these five stocks have been down 12% while the bottom 495 stocks in the S&P 500 have only lost 1%. This is why we should not give up on value stocks (such as those in the DFA funds).

Fourth, there is a big difference between Wall Street and Main Street. As investors, we are only focused on Wall Street (i.e., relatively large, publicly traded companies). But in our day-to-day lives we live on Main Street, and we have been witnessing the struggles of local businesses. This part of our economy is in shambles right now, and we all know people who are suffering greatly.

So, What Are the Risks Ahead?

Economists are concerned that only about half the jobs lost during the pandemic have been recovered. The other half are at risk for long-term unemployment, which will pose challenges for the entire economy.

Medical experts are concerned about a second wave of the virus, which could lead to more restrictions and lockdowns. That is occurring right now in Israel and Great Britain. The market will also be sensitive to any setbacks on the virus vaccine and its deployment.

State and local governments are starting to suffer from a significant tax revenue shortage while certain expenses (such as retrofitting schools) have gone up dramatically. These governments will be under significant financial strain for some time.

Congress and the president have been unable to agree on a second stimulus package. Fed chair Powell is strongly advocating for further fiscal stimulus to stave off severe economic consequences for those who have been most impacted by the virus.

Finally, markets are watching the election carefully, but they will become very concerned if there is no clear winner, or if there is a serious dispute about the results. One thing is for sure: do not expect definitive election results on the evening of November 3. Here are some important election dates to keep in mind this year.

November 3 – Election Day
December 8 – Election results must be certified by states
December 14 – Electoral college meets and ballots are cast
December 23 – Deadline for receipt of electoral college ballots by Congress
January 6 – Congress meets to count electoral votes
January 20 – Inauguration Day

So, Should I Reduce Risk in My Portfolio? If So, How Should I Do It?

Well, we all desperately want to know what the future will bring, but we must humbly admit that we do not know what is going to happen. ***We cannot reliably predict the future.***

Many investors will do absolutely nothing with their portfolios right now. And who is to say they are wrong? Many academic studies show that patient investors outperform their hypervigilant counterparts over the long run.

If you are currently in a well-diversified portfolio invested in a good asset allocation filled with solid investments that match your risk profile and long-term goals, you are smart to sit tight.

Unfortunately, most investors cannot say that about their portfolios. And there are certain investors who are confident that they know trouble is coming. They cannot and will not sit tight.

So, if you must make some moves, here are some smart, rational ways to reduce risk in your portfolio:

First, simply rebalance. If your asset allocation is out of balance, make the moves necessary to rebalance, especially if your stock allocation has drifted well above its target over the past few months. This is an easy and appropriate way for an investor to prepare for volatility (again, assuming the asset allocation is sound).

Second, change your allocation. If you want to take a more conservative posture, reduce your exposure to stocks and increase your bond and cash holdings. For example, if you have a portfolio of 60% stocks, 35% bonds, and 5% cash, consider moving to an allocation of 40% stocks, 40% bonds, and 10% cash. There are risks to this strategy. If you stay in this allocation for too long, you may reduce your expected return and be unable to reach your long-term goals. That is why this must be a temporary move. You should pick a date in your calendar to unwind this strategy, such as some certain date after the election, for example.

Third, reduce exposure to high-volatility investment strategies. Scan your portfolio for high-volatility investments. Look for strategies that are high risk, lack diversification, or have returns that are more volatile than the overall market. Consider replacing those strategies with highly diversified index strategies. For example, you could replace a small-cap energy stock fund with a larger-cap index fund. Additionally, you could replace an emerging market bond fund with a high-quality core bond strategy. These moves can be accomplished without changing your overall asset allocation.

These are just a few examples of many different alternatives. Sometimes, panicked investors will want to get out of the market entirely. This is usually the wrong move. When investors find themselves tempted to pull all the way out of the market, it is after the market has already moved down. They sell everything when it's down. Then they wait until markets feel "safer" to get back in. The problem is that while they suffered through the entire downturn, they miss out on most of the recovery. Buying high and selling low is not a recipe for long-term success.

When contemplating changes in your investment portfolio, ask yourself the following questions[1]:

1) Do I have the proper perspective?

Perspective is seeing all the relevant data and how it fits together. Perspective requires the sober analysis and consideration of relevant, objective data. To gain the proper perspective, you must be calm, rational, and open-minded. Passion and fear are your enemies here.

2) Am I being patient enough?

Patience is forbearance: tolerance and restraint in the face of provocation. It is the refusal of the investor to react inappropriately to disappointing events. In my experience, investors tend to make the biggest mistakes when they become fearful of losing money in a down market. When it comes to portfolio management, patience and discipline (close cousins) are usually rewarded.

3) Is it a matter of perseverance?

Perseverance means doing the right things in the face of difficulties, obstacles, or discouragement. Sometimes when the world looks bleak, we have to remember that the situation is temporary and that problems of today will be resolved, and new opportunities are never far down the road. Many investors have trouble distinguishing the difference between a poor investment strategy and a good one. If you have a poor strategy, then you should fix it. If your strategy is sound, sometimes you simply need to persevere.

If you are considering adjustments, always ask yourself what the cost would be if you were wrong. Only move forward if you can live with that cost.

As with any recommendation, you should consult with your own financial advisor about your particular situation or give me a call for a portfolio review.

I hope this newsletter finds you safe and well. Please reach out with your investment questions and concerns.

Thank you.

D. Austin Lewis

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[1] This section is based on Nick Murray's *Behavioral Investment Counseling* (2008) at pp.71–75 (emphasis added). Mr. Murray was the 2007 recipient of the Malcolm Forbes Public Awareness Award for Excellence in Advancing Financial Understanding.