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Factors In Focus

The Best Moves In a Bad Market

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In conversations I've had with clients over the last month or two, a few have expressed concern that what has, until now, amounted to a very modest decline could get much worse and have a material impact on their near-term goals.

Most others are taking this in stride, as even a short-term memory of the past reveals that things do not seem as bad as they did in the fall of 2011 when the U.S. government had its credit rating downgraded for the first time in history. We were also embroiled in a European debt crisis (stocks fell about twice as far from June through September 2011 as they have since the market peak last June). Of course, that memory includes the fact that stocks recovered fully in a matter of months and were continuing to reach all-time highs through last spring.

But there is one question I've been getting quite often from concerned and Steady-Eddie clients alike: *is there anything we need to do or do differently*? It turns out, there are some things we may need to do and consider.

#1—Revisit Your Goals

I remember a few discussions I had in early January when the market was down considerably. Clients, I think, expected me to launch into an extended analysis of the current financial situation and its impact on their portfolios but I had almost no thoughts on the matter.

My main reason for touching base was to make sure nothing materially had changed as far as the clients' long-term goals were concerned or their short-term need for ongoing cash flow (or continued savings). This was, and continues to be, the only significant factor, outside of making portfolio changes, that we can influence after the initial plan is established. It is the single most important driver of our investment plans.

Should we make changes to our long-term portfolios in the face of unpredictable and short-term market downturns? *Absolutely not*. Each portfolio is designed with an expected return that should fulfill our clients' lifetime goals as they've articulated them to us. Market gyrations don't influence those return expectations; the downturns are simply the manifestation of the unfortunate risk we have to endure to earn those returns (CDs don't fluctuate, nor earn anything).

If long-term goals have changed—let's say you decide you want to work a while longer (and therefore can save more), or you won't need cash flow from your portfolio as soon as you originally thought—then it may be time to adjust the plan. Or maybe we will just postpone the changes we were planning to inevitably make. But this is in response to changes in your financial situation, not changes in the market.

#2—Rebalance

When I say we don't need to make portfolio *changes*, that doesn't mean we don't need to do *anything* to your portfolio. Part of our ongoing management is to track your current portfolio's value not just relative to its long-term expected trajectory, but also in relation to its original design. Should any holding—US small value, short-term bonds or whatever, deviate materially (+/- 20%) from its original target, we will want to rebalance it back to its intended weighting. Keeping your portfolio in line with how it was initially allocated ensures that we get as close to the long-term returns of that allocation as possible without any more or any less risk.

Nothing prevents us from rebalancing the portfolio on a daily basis. It's just not sensible. Schwab charges transaction fees to buy and sell that we always want to minimize (and of course, we don't earn any of) and in taxable accounts there are capital gains to consider.

So the best way to rebalance, the way that we often do it without you expressly knowing, is to use the natural cash flows we earn from dividends and capital gains. When one fund distributes income, we may redirect those proceeds to another part of the portfolio that's underweighted. If these periodic additions have not been sufficient to keep the portfolio in line, then we'll need to take the additional step to sell assets that have performed better (i.e. short-term bonds) to buy more stocks. At all times, this will be done as tax efficiently as possible, but we won't let the portfolio drift dangerously out of allocation just to avoid some small tax costs.

#3—Save and Spend Smartly

The next issue we need to consider, which is associated with rebalancing and the overall asset allocation, is where we are directing our new portfolio contributions and from where we are taking our cash flow distributions. This is a crucial part of our ongoing planning and portfolio management process and also helps alleviate client concerns that short-term market volatility will have an adverse impact on their near-term goals.

Savers

It's natural for clients saving for retirement to worry that stock market declines are adding years to their working careers—they'll not be able to retire on time if they don't see a bull market or sustained rise in stocks. But that's not necessarily true. Continuing to save on a regular basis and directing those savings into stocks—sometimes at excessively low prices (think 2002, 2009, 2011 and today) and always into the asset classes that are slumping most (which today includes small cap and international stocks), allows you to take advantage of stock market volatility. You potentially earn more on your periodic savings (through extreme "buy-low" behavior) than the long-term, point-to-point return on your portfolio. You absolutely need to keep saving and we need to keep investing wisely. That *is* proactively doing something.

Spenders

For retirees who look to their portfolios for income, stock market declines present a different kind of anxiety. Will you spend too much or will a stock decline cause you to run out of money? It's doubtful. Long-term investment returns that come in below our average spending rates, typically due to an overabundance of low-returning bonds or poor timing decisions, is the main culprit of a portfolio that continues to dwindle over long periods of time, not temporary losses.

What does change for a retiree when stocks decline is from *where* they get their cash flow. During bull markets, when stocks are appreciating, we regularly sell shares of stock mutual funds (and more specifically the stock asset classes with the best recent returns) to generate the necessary income. When stocks are down, we begin to sell bond mutual fund shares instead. The bonds we own are high quality and short term. They're expected to hold up well when stocks are falling and to provide us a stable asset we can sell as we wait for stocks to recover. In doing so, we ensure that we don't turn temporary "paper" stock losses into permanent ones.

Our primary bond strategy—the DFA Five-Year Global Bond fund, is a rock. It's been around for almost 30 years following the same time-tested strategy it did in 1990. It has weathered 1998, 2000-2002, 2007-2009, 2011 and this recent decline. We're confident it will perform predictably in future bad markets as well.

#4—Turn Loss Lemons Into Lemonade

Another opportunity we have when stocks decline is to revisit the average price we've paid for our mutual fund shares. When the current price is below its cost basis by a meaningful amount (10% or more), it may be worthwhile to sell the position and recognize the loss. This loss can be used to offset gains in other parts of your portfolio this year or in the future or reduce the amount of your income subject to taxes.

This is not a risk-free transaction and not nearly the panacea that some investors and "robo-advisors" make it out to be. First, you have to buy something different with the proceeds and stay out of your original position for at least 30 days. It can be similar but not identical. By definition, this means switching to your second best option for that asset class. You might be stuck with that holding if it appreciates materially over the next month—if you sell and return to your original position after 30 days you could recognize a short-term capital gain.

Additionally, you've lowered your taxable cost basis. This is fine if, when you eventually need cash flow from your portfolio, you're in a lower tax bracket and don't mind the additional income. But some clients do such a good job of saving and investing over the years that their income is as high or higher in retirement than it is when they're working, especially when you consider the loss of tax deductions on a house that is eventually paid off and the end of tax-deductible contributions to company retirement accounts.

Tax-loss-harvesting may make sense, especially for clients who don't ever plan to spend their assets and who are, instead, investing to provide their loved ones a financial legacy during their lifetimes and after they've passed away. But we always want a qualified CPA in the discussion to ensure that we're not overlooking some unique aspect of the client's tax situation.

Unconventional Management

Individually or collectively, these probably are not the "things" you were thinking of when I said there were some things we might need to do. Of course, many financial advisors and the financial media encourage wholesale portfolio changes at every opportunity. It's easier and more headline-worthy than "stick to your plan" or "stay the course."

When your plan is a good one, with your unique financial goals carefully considered, think about small and infrequent changes as a vote of confidence in its original and enduring design—not stubbornness or unwillingness to change.

Along those lines, if you have friends or family members that appear particularly unnerved with the financial markets or their current financial situation, it might be a good time to introduce them to Servo and a better way to invest.

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