DUNCAN & HALEY LTD

Market Volatility Update

5-Year History of the S&P 500 as of 4/29/2022.

The market is getting volatile again, and so we wanted to reach out and share our thoughts on what not to do, but also talk about what TO do. Our philosophy on trying to time the market has not changed. Remember, when attempting to time the market, you must get two market timing events correct, which is often impossible. Investors frequently sell when the market is falling or has already fallen, which means they must buy back in when the market and sentiment are even darker than when they were first frightened into selling. As a result, they buy back in when they think the market is looking or feeling better, but it is then 10% higher than when they sold. The challenge is that the market moves ahead of the economy or things looking or feeling better. This scenario is the most common and easily avoidable investor mistake that we see happen. When we discourage timing the market, we spend a lot of time talking about what NOT to do. How about we talk about what TO do?

There are helpful actions that *can* be taken in rising or falling markets that are additive to your financial outcomes and provide a way to take positive action instead of reacting when things get volatile. When the market falls, it is natural to want to respond. Here are our best ideas.

Rebalance

Good news for some! If you invest in a model portfolio or a target-date fund in your 401k plan, rebalancing happens automatically for you, generally, every quarter. Year-end rebalancing has been particularly helpful this year.

Here's how it works for a review and for those that pick their own individual investment funds. First, an investor needs to start with a big picture, long-term target allocation for their portfolio to rebalance back to. Examples of allocations would be 80/20 or 60/40 stock to fixed income (bonds and cash). Many break this down to more granular asset classes, as do most model portfolios, with divisions for small, mid, and large-cap stocks (company sizes) and value versus growth styles of management (dividend payers versus growth companies). As the market rises, the stock allocations will rise above the investor's target. For example, the 80% they have in stocks may increase to 85% or 90% of the portfolio as the market increases. To rebalance, they

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must sell enough stocks to reduce this percentage to 80% and then reinvest the proceeds in fixed income, which would naturally fall below the 20% target. The idea is to "sell high and buy low." When the market falls, the exact opposite should happen. The 80% targeted for equities may fall to 65% or 70%. The investor must buy enough stocks to rebalance and return to the 80% target by selling fixed income.

If you build your portfolio, you are responsible for rebalancing your allocations. Most recordkeeping systems allow participants to set their own automatically rebalancing schedule, but the investor must log in and take that action to make it happen.

Actions to Take - Review your investments: Do you have a model portfolio or target-date fund? Is it the right one for your time horizon? If you do not enjoy doing the research and managing the details of selecting your own mix of funds, consider changing to a model or target-date fund so it's done professionally for you. If you enjoy choosing individual funds on your own and want to continue doing so, ensure that you review your targets and set up automatic rebalancing, or set your schedule to rebalance manually.

What to do in a rising or record market

The market is not rising, so we will not spend too much time on this. However, the following practical actions will be helpful to remember when the market is doing better in the future.

Rebalance: Although already discussed, rebalancing should be emphasized to highlight its importance in a rising market, especially in the tax-deferred environment of a 401k plan or IRA.

Review your target allocation: Is it an ideal time to de-risk your target allocation? If you are in a model portfolio that auto-adjusts, like a "Glide Path" or target-date fund, this happens automatically for you. If not, a rising or record market is an excellent time to review your overall portfolio targets. A general rule for gauging risk while incorporating your withdrawal schedule is to look into the future, estimate how much you will withdraw each year, and ensure you have the following 7-10 years of withdrawals invested in fixed-income income investments. If you are 11+ years away from that, you do not necessarily need fixed income from this perspective, but many models and target-date funds already have 10%-20% in fixed income at that stage. Conversely, if you are retiring next year and plan to withdraw $30k per year, we suggest having at least $200-$300K in fixed income to cover those withdrawals. High markets are ideal for reviewing your minimum, suggested fixed-income allocations.

What to do in a falling or bear market

Rebalance: Again, we must emphasize the importance of rebalancing. It does not feel great in a falling market to buy more of what is decreasing, but those equities that fall are likely your longest-term assets. When rebalancing, we do not always time it ideally, but we have always been satisfied with the results over the long term. Take the opportunity to add to your stock positions if they fall below target.

Tax-loss harvesting opportunities: In taxable accounts, take advantage of tax-loss harvesting opportunities. You can take tax losses now and use them in the same year or carry them forward in future years. To tax loss harvest, you sell an investment showing a temporary loss. Many bonds and bond funds are current examples of this due to rising interest rates. After selling the investment, you reinvest the proceeds in something similar. It cannot be the same security for 90 days, or the tax loss will be canceled due to the "wash-sale" rules, so selling and buying something similar is a way to harvest the tax loss but remain invested.

Gifting: If you have a large estate and are trying to minimize gift and estate taxes for your family long-term, gifting shares while they are temporarily depressed can help with this. Many families have created investment-focused LLC entities and use reduced valuations to give gifts to children and grandchildren. Estate and gift tax can run 40%+ depending on your state of residence. Facing these taxes is a good problem to have, but they can be very costly and destructive to a business and capital if not planned for.

Roth Conversions: If you've been contemplating a Roth conversion (where you transfer money from your pre-tax account to your Roth account, receive a 1099 for the amount after year-end, and pay the tax with other monies), a market downturn can be a good time to execute on it. An example would be an S&P 500 stock fund. Pre-correction, it's trading at $1 per share. If you planned to transfer 10,000 shares, it would be worth $10,000, and if converted pre-correction, would result in a $10,000 1099 (income you must include on your tax return). However, if the market retracted by 30%, the shares would be trading at 70 cents per share. The 10,000 shares would only be worth $7,000, and that would be the amount on the 1099, which represents a 30% decrease in the tax bill for the conversion. Then, if/when the market recovers, the exacerbated gains in the recovery become tax-free. So, think of market corrections as discounts on Roth conversions. Watch out for tax brackets, though! You want to make sure you are aware of how the amount of a conversion adds to your income and where that puts you in the tax bracket schedule for the extra income.

Review your cash flow needs and fixed income allocation: If you are using a model or target-date fund, you will likely have ample fixed income in your portfolio to cover the next 7-10 years of withdrawals, but everyone's plan is different. It is good to review your plans and double-check your investments. Knowing you have the following 7-10 years of needed withdrawals covered helps you think long-term opportunistically for the stock side of your portfolio.

When is a good time to buy?

Our best guess has us interested in rebalancing if the DOW drops into the mid 32K range and the S&P in the 4100 range. If this occurs, it will put stock market valuations at the same level as one year ago.

Do you need help mapping out a cash flow schedule or mapping investments to YOUR financial plan? Give us a call! We are here to help.

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