Financial Alternatives
integrated wealth management

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We Just Experienced One of the Most Volatile Stock Markets in Recent History

Illustrated below is the stock market's 10 best and worst quarters since 1926 as measured by the S&P 500. As you can see, the first quarter of 2020 ending in March was the ninth worst quarter; and that was immediately followed by the ninth best quarter ending in June! This type of major drop one quarter and immediate rise the next quarter is a rare occurrence, but it has happened – as you can see for quarters in 1932 and 1938 in the table below.

These sharp corrections often cause impatient investors to panic, abandon their investment plans and sell their stocks at a loss to avoid further losses. Investors like these may tell themselves they will get back into the market once things calm down. And as so often happens markets rebound quickly before they have a chance to buy back their investments and they are left sitting on their losses with their funds in cash.

These types of infrequent stock market drops also create opportunities for long-term investors. In this newsletter we will briefly cover some of the strategies we used for clients in light of the volatile market conditions we experienced the last several months.

S&P 500 Best & Worst 10 Quarters of Performance Since 1926

Worst Quarters		Best Quarters	
Jun 30, 1932	-37.68%	Jun 30, 1933	88.84%
Sep 30, 1931	-33.62%	Sep 30, 1932	84.97%
Dec 31, 1929	-27.75%	Jun 30, 1938	38.40%
Sep 30, 1974	-25.16%	Mar 31, 1975	22.94%
Dec 31, 1987	-22.63%	Jun 30, 1935	22.28%
Dec 31, 2008	-21.94%	Mar 31, 1987	21.33%
Dec 31, 1937	-21.40%	Dec 31, 1998	21.30%
Jun 30, 1962	-20.62%	Sep 30, 1939	21.23%
Mar 31, 2020	-19.60%	Jun 30, 2020	20.54%
Mar 31, 1938	-18.59%	Mar 31, 1943	19.82%

Source: S&P, Dimensional Fund Advisors

What Did We Do to Handle the Market Correction?

While we do not believe in our (or any other professional's) ability to reliably predict the direction of the market, there are conditions that prompt reassessments and individual portfolio changes for long-term investors. For many of our clients, we implemented at least one of these techniques during the last two quarters: 1. Rebalance portfolios back to established targets; 2. Strategic tax swaps to reduce taxes; and 3. Increase target equity allocations. Here is a look at each of these methods in greater detail.

Executive Summary

- The quarter ending March 31st was the ***9th worst*** quarter of stock market performance; and the quarter ending June 30th was the ***9th best***.
- Investors who swapped from stocks to cash after the steep drop in March missed the subsequent rebound.
- We took measures in light of the situation by rebalancing client portfolios and executing tax swaps.
- We are living through an unprecedented period of history and we expect markets to remain uncertain for some time to come.

Rebalance Portfolios

Rebalancing a portfolio to an established target is simple in principle but can be difficult to execute for several reasons. To illustrate how rebalancing works, here's a simple example:

Assume a client had a $1,000,000 brokerage account originally consisting of a target 60% stock and 40% bond allocation. The next quarter the stock allocation dropped by 20%, but the bond allocation did not change. The portfolio would now consist of about 54.6% in stocks ($480,000) and 45.5% in bonds ($400,000). The portfolio lost $120,000 or 12%, the stock allocation of 54.6% is less than the desired 60% and the bond allocation of 45.5% is greater than the desired 40%. Rebalancing this portfolio requires selling $48,000 dollars of bonds and buying $48,000 of stocks, which would bring the now $880,000 portfolio back into its desired 60% stock and 40% bond allocations.

Rebalancing can be hard to do emotionally for the simple reason that if you rebalance a multi-asset portfolio and markets continue to fall, you will lose even more money than if you did nothing - it's human nature to try to avoid this outcome. Nobody can accurately forecast when the market will hit bottom; thus it requires courage to attempt a rebalance in the face of this.

Since most household portfolios are made up of numerous account types such as IRAs and taxable brokerage accounts, and because each of these accounts typically contain multiple stock and bond investments, rebalancing can quickly become a very complicated process. When you multiply this complexity by the number of clients a firm serves, you can see how laborious rebalancing can become without having the proper technology and processes in place long before they are needed.

After the experience of the 2008-2009 financial crisis, we decided to invest in advanced portfolio management systems to handle customized rebalancing across many client accounts. Because of this investment, we are able to rebalance client accounts swiftly and efficiently when necessary - and this year was no exception.

The types of corrections we just experienced are scary, and it takes a thoughtful plan of action as well as fortitude to avoid the emotional decisions that one may later regret. It is our job to remain calm and help our clients make better long-term investment decisions, and we work hard to do just that.

Strategic Tax Swaps to Reduce Taxes

Managing a portfolio to realize tax losses can boost long-term performance compared to a simple buy and hold approach – often this is referred to as tax-loss harvesting or tax swaps. Using the same hypothetical client portfolio from above, we can explain how tax swaps work and how they can reduce your taxes.

The account starts out with $600,000 in stocks and $400,000 in fixed income, then stocks fall by 20% and bonds remain the same. After the drop, the stock allocation is now $480,000 (a loss of $120,000) and the bond allocation is still $400,000. This $120,000 drop in the stock allocation is not really a loss for tax purposes unless it is sold. Once sold, the loss can offset any gains in the current year or be carried forward to the next year. Assuming a 20% capital gains rate, this sale would theoretically save about $24,000 in federal income taxes and potential state income taxes as well.

Selling an investment that has dropped in value can create several challenges. First, IRS regulations state that investments sold at a loss cannot be bought back for 30 days or the loss will be disallowed for tax purposes – this is called a "wash sale". Selling and sitting out of the stock market could force you to "sell low and buy high" if the market rebounds during the 30-day wash sale period.

One way to get around this 30-day rule and the impact of sitting out is to buy a replacement investment that is similar to the one sold. Yet another IRS wash sale rule requires that any replacement investment not be "substantially identical", or again the loss will be disallowed for tax purposes. For example, if you sell a 'Brand A' S&P 500 ETF at a loss and then buy a 'Brand B' S&P 500 ETF you most likely have violated this rule. However, if you sell a 'Brand A' S&P 500 ETF at a loss and then buy a 'Brand B' U.S. Total Market Index mutual fund, we believe it's much less likely the IRS would disallow the loss.

Properly executed tax swaps will net a tax loss and also allow you to participate in a market rebound that may happen during the subsequent 30 days. After 30 days you could theoretically swap back to the fund originally sold, or stay in the replacement fund.

Here again, the investment we made in our portfolio management technology enables us to execute your tax swaps effectively. The recent market volatility gave us the opportunity to execute many tax swaps so far this year for our clients.

Increase Target Equity Allocations

We work to get a good understanding of our clients over time, and in some cases we were aware that some were willing and able to buy into a market correction if one should occur. We worked with some of these clients to not only rebalance their portfolios but also increase their allocation to equities.

Summary

We are living through an unprecedented period of history and we expect markets to remain uncertain for some time to come. The stock market drop in March was rapid and deep, and the rebound was just as swift. This correction is certainly one for the history books, but we still do not know whether the worst is behind us already or yet to come.

This recent correction provided us the opportunity to rebalance portfolios and to execute tax swaps while stocks were down, and we applied processes and technology to carry this out effectively.

We encourage you to stay resilient and resist the temptation to make major changes to your financial and investment plan due to anecdotal information. We are confident that we will get through this and are here for you to assist you along the way.

Please call us if you would like to discuss your investments or any other aspect of your financial life in greater detail.

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