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# The Question Every Advisor Must Answer

by Allan Roth, 6/8/20

With the recent market rally, stocks are again near their all-time highs. But we face a perilous economy, coupled with the threat of a resurgence of the coronavirus. Here's what I tell clients who are dead-certain that the stock market is due for a significant correction.

The perception that each bear market is different is typical, but I'm hearing many people say, "This time really is different." Never before has something as small as a microbe changed our lives so profoundly and inflicted permanent damage on our economy. Let's add nationwide social unrest and a dysfunctional political climate. With the bankruptcy business booming, and the lack of assurance that we will ever come up with a vaccine, I'm hearing statements like the following:

- An economic depression is possible, if not likely.
- There would be at least a 50% market decline.
- The chance of a rally, much less getting anything close to historical stock returns, is near zero.
- A state-issued general obligation (GO) muni bond held to maturity is safe – no defaults since 1932 – and yields 5% on a taxable equivalent basis.
- Take everything out of stocks for at least six months or until after a big correction.

Though I agree with some of those comments, here is how I respond to them, followed by what I advise clients to do.

What I tell clients, oddly, seems to make them feel better.

## **An economic depression is possible, if not likely**

It absolutely is possible, and it was possible last year as well. The probability of a

depression is greater now than it has been in my lifetime. That said, I doubt it is likely.

The Federal Reserve has tools it didn't have during the Great Depression. Never before have the world's scientists, corporations, and governments come together to find a global solution to this pandemic. This isn't the first pandemic the world has seen and capitalism has managed to survive.

Many others don't share my view. Jeremy Grantham has been pessimistic on stocks for many years and now his GMO fund is now shorting global stocks, saying markets are out of step with the real world. Grantham did call the bottom right in March of 2009. But predicting depressions isn't easy. Those who bought into the logic in Harry Dent's 2009 book, *The Great Depression Ahead*, missed out on much, or all, of the longest bull market in history. After all, the financial system seemed like it would collapse back then. The cause today is different, but the fear is the same.

### **There would be at least a 50% market decline**

No "would be" about it; there will be a 50% market decline. After all, we've had two market declines of 50% or more since December 31, 1999, and there are more in the works. If I knew when, I'd be giving Jeff Bezos some competition in becoming the world's first trillionaire. In a mere 33 days, from February 19 to March 23, the U.S. stock market gave up 34.8%. At that rate, two more weeks would have hit that half-off sale.

Let me fess up. If my crystal ball told me that we were going from the lowest unemployment rate in modern history to 14.7%, I would have thought the market would be down 70-80%. I would have sold all of my equities and had a humongous tax-bill. This may be the first time I'm glad I don't have a crystal ball.

The market is certainly betting that the Federal Reserve and science will solve this COVID crisis. U.S. stocks are down only 3.1% this year as of June 4, 2020, as measured by the total return of the Wilshire 5,000.

But, of course, markets have been wrong before.

**The chance of a rally, much less getting anything close to historical stock returns, is near zero**

I couldn't disagree more with the first part of that statement. The chance of a rally is actually 100%, as stocks are up 41.4% from the low as of June 4, 2020. Technically, we are past a rally and in a full-fledged bull market. I can't tell you how many times I've heard that this bull wouldn't, or even couldn't, happen until the pandemic was behind us. But the stock market is forward looking. On March 23, it priced in worse news than what actually happened, or at least had happened so far.

I agree with the second part, however. I don't think we will get long-run historical returns on stocks of 9-10%. It is not impossible, but it is improbable. We also are unlikely to get the same bond returns as in the past. In fact, the only two things I can guarantee is that forward-looking stock returns will be higher today than they were on February 19 when the market peaked, and high-quality bond funds will return less than stock. That's because stocks fell and bonds surged.

**A state-issued GO muni bond held to maturity is safe – no defaults since 1932 – and yields 5% taxable equivalent basis**

Muni bond yields have increased as prices declined. Conversely, Treasury yields plummeted as prices skyrocketed. As of June 3, a 10-year AAA muni was yielding 1.67% tax-free, while the same maturity U.S. Treasury bond was yielding a federally taxable 0.76%. But this is no free lunch. It's true that during the Great Depression, actual defaults were rare. But there weren't \$2-\$3 trillion of unfunded pension and health care liabilities with massive payouts from the retirement of the baby boomers. And that current shortfall is estimated by actuaries assuming very high future returns, which as I have previously written, is unlikely. Other estimates now exceed \$6 trillion.

If we have a lasting depression and stocks do poorly, there is only one way the state GO bonds won't default – a U.S. government bailout that would make the recent few trillion-dollar deficits look miniscule. Again, it's possible, but do you really want to bet most of your clients' assets on it? Just recently, Senate Majority Leader Mitch McConnell stated, "I would certainly be in favor of allowing states to use the bankruptcy route."

**Take everything out of stocks for at least six months or until after a big correction**

The late John C. Bogle once stated, "You must be right twice. So if you get out now, and

the market goes way down another 15 or 20%, so many investors will be so scared they won't get in.”

But Jack Bogle said that he reduced his exposure in early 2000 from 75-80% equities to 25-30% because he felt that stocks were too overvalued at multiples of nearly 40-times current earnings. He noted that bonds were yielding 7%. Today, however, multiples are nowhere near that (though we don't know future earnings) and high-quality bonds are yielding well under 2%. Another difference is that he sold before the decline, though stocks have now largely recovered. I suspect he would tell us to do nothing in today's market. I can picture him saying, “Don't do something, just stand there!”

### **What I tell clients**

No one knows the future. Investing has always been and will always be risky. Rebalancing has worked well during the COVID crash as it has for the past three bear markets.

For the past couple of decades, I typically take risk off the table for my clients because they have already “won the game” and have enough money to fund their lifestyle. I don't use a risk profile questionnaire, partly because it ignores the client's need to take risk. I try to assess need to take risk and then do my best to have them imagine the pain they would feel with an 80% stock plunge. I discuss both probabilities and consequences. I let them know that picking their allocation is the second most important decision they will make – the most important is committing to stick to it. And I often negotiate with them to agree on a more conservative allocation but give them permission to be more aggressive in a bear market. Nobody has told me they want more stocks lately, as the willingness to take risk is highly correlated with stock performance itself.

Don't confuse risk and volatility. Bailing on stocks now reduces volatility, but may lead to the ultimate risk in that your client will never be financially independent and able to pursue other endeavors that bring happiness.

Balance is key. Recently I disagreed with Fisher Investments' quantitative model claiming 100% stocks in retirement is safe. That was ridiculous, but so is bailing out of all stocks now and going to 0% equities. Going 100% in anything, including GO munis, is

dangerous.

I could tell someone to have no equities. I've seen a few portfolios in the last couple of months where the person did completely sell out of stocks. They probably shouldn't get back in, as their behavior in the last plunge is the best predictor of what they will do in the next bear or round two of a possible COVID bear. If someone previously took on more risk than they needed to, I'd recommend taking some risk off the table.

But should my advice prove to be wrong, or should capitalism actually fail, I assure my clients that, "I'm going down with you." Oddly, it makes them feel a bit better. People hate losing money, but they hate it a bit less when others lose as well.

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