Market Perspectives

GoalBridge Wealth Management

Stock Investing Works

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It was a rough January for asset prices. The S&P 500 was down 5.3% and the U.S. bond market dropped by 2%. Tech stocks fared much worse with the NASDAQ retreating 9% from where it ended 2021. This dismal start to the new year was preceded by three consecutive years of double-digit equity returns.

Since March of 2020 – the early days of the COVID-shutdown-induced recession – the Federal Reserve has been a huge monthly buyer of U.S. treasury bonds and mortgage-backed securities. The Fed's largescale purchases of these debt securities effected historic low interest rates and a rapid economic recovery. With the economy now nearing full employment, and inflation running hot, the Fed is shifting from ultra-accommodative monetary policy toward a more neutral position. The Fed's bond purchases are scheduled to conclude in March of this year, and interest rates have moved higher in anticipation of this policy shift.

That's not all! As headlines indicate, the Fed is also preparing to begin hiking the fed funds rate [from zero]. This action also exerts upward pressure on interest rates.

What does this mean for investing?

It means January was a big down month for stock and bond prices. January is, of course, a one-month period. We all would prefer every month to be up big, but it wouldn't be investing if that was so. Savings-based instruments offer more certainty and much less volatility of short-term returns. Given the current rates of interest and inflation, the certainty offered by cash and CDs could lock in somewhere around -5% for an annualized *real* (inflation-adjusted) return for 2022. We should probably take the -5% if every month of investing was a repeat of this past January; and I should probably move onto selling insurance – *not that there's anything wrong with that.* Fortunately, January's market action was an anomaly.

There isn't much to point to in the way of causal relationships between rising rates and falling stock prices. The 10-year U.S. treasury bond yield rose from 1.75% to 3.25% in 2013. This was the largest annual increase in interest rates in over a decade. The S&P 500 returned over 32% that year – the largest since 1997 – while interest rates climbed. Similarly, the most recent Fed funds rate increase cycle kicked off at the beginning of 2015 and continued throughout 2018. The S&P 500 returned 32% over this 4-year period. Economic growth was present in both cases, as it is now. This does not suggest rising interest rates cause stock prices to go higher, but it pretty much proves that rising interest rates are not always detrimental to the performance of stocks.

> ***"I have never been able to predict interest rates. I've never tried, I don't try. My circle of competence doesn't include the ability to predict interest rates a day from now or a year from now or five years from now. But that doesn't mean that I can't do well investing over time."***
>
> Warren Buffett

One more point on interest rates. Up seems like the path of least resistance today, but it's not a certainty that rates will soar significantly higher from here. Interest rates are driven by global supply of and demand for bonds – not only actions taken by the Fed. A quick move up in rates rattled markets in January, and that bit of history is now known. If we aren't selling at depressed prices, then it is a temporary change in value.

Thinking about changes in value

Watching house prices plummet during the financial crisis was an uncomfortable reality for homeowners. A house valued at $300,000 in 2007 would be lucky to bring $250,000 on the market a couple of years later. Who pocketed the $50,000 when the price dropped? Some greedy bankers... a realtor driving around town in a shiny SUV? Clearly no one. Housing demand dropped and the price came down. Still the same house. Maybe it wasn't worth $300,000 to begin with. Or maybe $250,000 was a bargain. It's for "the market" – buyers and sellers coming together to transact ownership – to decide at any point in time. If the owner of the house wasn't planning to sell at $300,000, seeing the value go to $250,000 probably didn't cause the desire to sell increase. Not really the point, but odds are good that the house would easily sell for more than $400,000 today.

Similar price/value discovery goes on with stocks. When demand for stocks decreases, prices go down. And when demand increases, prices go up. There's a noteworthy difference in what typically occurs when the value of the housing market drops as compared to the value of the stock market. Housing prices fall when demand drops, and if you want to sell your house you will have to accept whatever the highest bidder is willing to offer. Most owners of homes are not selling when prices are down – few transactions are being made – and therefore minimal amounts of actual cash [relative to the size of the overall market] are being pulled out of the housing market.

Stock prices change in real-time and can be bought and sold on an exchange in a fraction of a second – much less friction than buying or selling a physical property. Stocks are "liquid" assets and can be converted to cash quickly. When stock prices drop there is often a frenzy of transactions that result in a large volume of cash being pulled out of the market by sellers. This cash doesn't typically sit idle for long. The last thing we want to do as investors is ride the market down, sell stocks and then miss the eventual recovery as cash comes back into the market.

The fact that both stocks and bonds were sold off in January could be a positive for stocks in the near term. Again, this means there is more cash sitting on the sideline now than when the year began. Had stocks dropped while bonds increased in value, this could have suggested that a meaningful share of the money flowing out of stocks was being repositioned into bonds. Money invested in bonds, as opposed to being held in cash, would likely to be slower to flow back into stocks. Cash clearly began flowing back into stocks at the end of January with the S&P 500 moving higher by 4.4% in the final two trading days of the month. A saving grace to an exceptionally volatile first month of 2022.

Volatility is a good long-term investment

In finance, risk is often measured in terms of volatility. Volatility measures the frequency and magnitude of changes to an asset's price. Let's assume long-term returns for stocks have been 10% per year while bonds have returned 4% per year, which is largely reflective of reality. Stocks are considered risky assets. Bonds are considered non-risky assets. The 6% differential between the historic return of stocks as compared to bonds is considered the "risk premium." Investors willing to own risk assets must have the opportunity to earn a premium as compared to owning non-risk assets. This risk premium could just as well be defined as the volatility premium, in my opinion.

Experiencing volatility in the value of asset prices is the cost of earning premium returns over a long period of time. This is stock investing at its core.

Volatility premium expressed in dollar terms – how much more the value of assets could grow investing in stocks versus bonds over long periods of time.

Hypothetical Growth of $250,000

	4%	10%	Volatility Premium
10 Years	$370,000	$648,000	$278,000
20 Years	$548,000	$1,682,000	$1,134,000

Each investor has their own specific set of personal circumstances that informs how much exposure to volatility may be appropriate. Earning the volatility premium – the long-term excess return of stocks over bonds – is not a free ride. You're going to experience a lot more fluctuation in the value of your portfolio owning stocks. This

> *"Periodic setbacks will occur, yes, but investers and managers are in a game that is heavily stacked in their favor. (The Dow Jones Industrials advanced from 66 to 11,497 in the 20th Century, a staggering 17,320% increase that materialized despite four costly wars, a Great Depression and many recessions.) Since the basic game is so favorable, Charlie and I believe it's a terrible mistake to try to dance in and out of it based upon the turn of tarot cards, the predictions of experts, or the ebb and flow of business activity. The risks of being out of the game are huge compared to the risks of being in it."*
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> Warren Buffett

conversation is intended to help maintain the perspective that over long periods of time you are well rewarded for the willingness to withstand the short-term volatility associated with owning stocks.

As stated, stock prices came down in January. The Fed is responding to excess inflation by shifting away from hyper accommodative monetary policy, which has put some upward pressure on interest rates. The economy is strong and virtually anyone who wants a job can find one. Each of these are observations of short-term conditions, and none of them suggest to me that stocks are doomed. Investors are better served aligning investment decisions with long-term principals than reacting to short-term concerns. Although not in a straight line, stock prices have been rising through concerns and uncertainty since long before anyone reading this was born. That should be a trend we are slow to bet against.