

Modern retirement monthly

Portfolio management and black swans

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- The current economic and market environment is best described as a "black swan."
- Despite high volatility, equity markets have held up well.
- We believe investors would do well to remain focused on the things they can control: their asset allocations, financial plans, insurance and hedging strategies, and liabilities.

In the investing world, "black swans" are events that come as a surprise and have a major effect, requiring a broad reassessment of the economy and markets. The COVID-19 outbreak meets all of these characteristics.

Why "black swan"? Most swans are white, and in Europe black swans were thought to be mythical—so much so that "as rare as a black swan" became a common phrase—that is, until explorers discovered them in Australia in the 17th century.

Global pandemics are rare events. In fact, there are few people alive today that were also around in 1918 during the Spanish flu pandemic, so it is excusable that many of us had implicitly assumed global pandemics no longer existed. In regards to COVID-19, there remains a high level of uncertainty around our ability to contain the disease, its communicability, and the stress that it will put on healthcare systems globally. It's a clear human tragedy in the making.

We're not epidemiologists, but we are economists and investment strategists. Accordingly, we'll refrain from any forecasts regarding COVID-19 and focus specifically on guidance for managing portfolios as it applies to investors approaching or in retirement.

A recap of 2020 year-to-date

From an economic perspective, it's clear from the impact in China, South Korea, and other parts of the world that the economic disruption from COVID-19 could be huge in the US. The concern is that the economic supply shock (supply chains are disrupted) can easily become a demand shock (people consume less) as we take precautions to slow the spread of the virus. In response, the Federal Reserve cut the federal funds rate target by 0.5% on 3 March, but long-term interest rates have still fallen precipitously (Fig. 1). Long-term interest rates are declining because market participants expect lower economic growth and lower inflation. If the US experiences the same type of contraction we saw in China, the global economy could be in a recession by late spring.

Against that economic backdrop, equity market volatility has risen dramatically (Fig. 2), and equities have sold off. Daily moves of 1–3% have become normal, and as of 5 March equity markets had declined 4–10% year-to-date across the globe. High-quality bonds have served their purpose. Year-to-date, the Barclays US government bond index has appreciated 5%, and long-duration Treasuries are up 14%. Added together, globally diversified moderate portfolios have only declined about 3% this year (Fig. 3).

Managing through extreme uncertainty

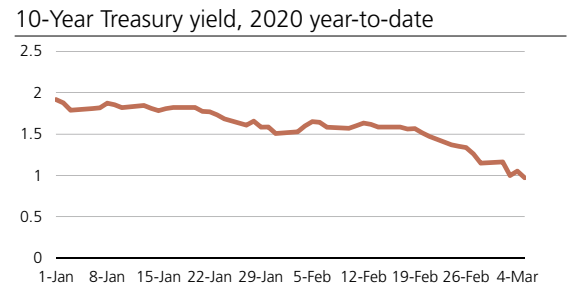
In an environment of extreme uncertainty, we would all do well to remember Epictetus' words about the dichotomy of control:

"The chief task in life is simply this: to identify and separate matters so that I can say clearly to myself which are externals not under my control, and which have to do with the choices I actually control."

We don't control the markets, but we do control our asset allocations, our financial plans, our insurance and hedging strategies, and our liabilities. Most importantly, we control our behavior. Instead of trying to find a crystal ball, we remain focused on the actions that remain within our control.

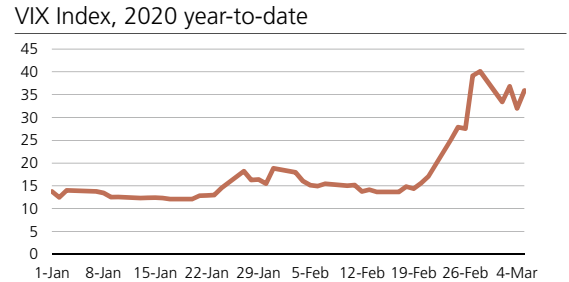
- Don't panic. At this point, the equity market decline has not been an unusual or unprecedented market event (Fig. 4). Thirty percent annual gains require accepting occasional 10% declines.
- If you have a "fire drill" plan for responding to market declines, start implementing it. Common actions might include rebalancing, putting "dry powder" cash to work, and tax loss harvesting when possible.
- If you're a bit apprehensive about current losses, it's a good time to run stress tests on your portfolio and see how they could impact your overall plan. It's important that there's not a mismatch between the potential bear-market drawdown for your portfolio and your capacity to absorb those losses while waiting for a recovery.

Fig. 1: Long-term interest rates continue to decline



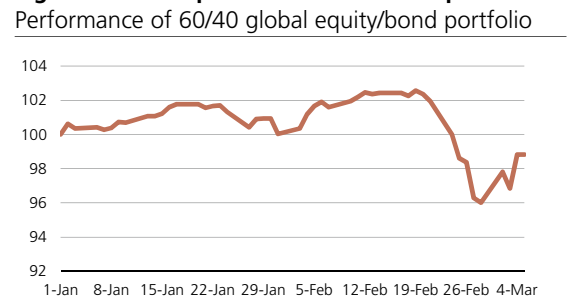
Source: Bloomberg, UBS

Fig 2: Market volatility remains elevated



Source: Bloomberg, UBS

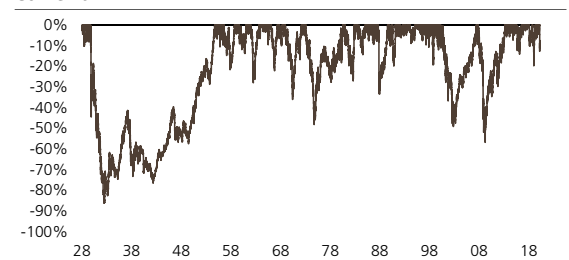
Fig. 3: Balanced portfolios have held up well



Source: Bloomberg, UBS

Fig. 4: The current US equity draw down has been modest

Peak-to-trough drawdowns for the S&P 500, 1920–current



Source: Bloomberg, UBS

- Use our Liquidity. Longevity. Legacy. framework to put context around your assets and what a sell-off would mean to you personally. A Liquidity strategy is especially valuable in times like this.
- Finally, if you come to the conclusion that you need to make changes, don't be afraid to do so. There's wisdom behind the saying, "If you're going to panic, panic early." The current decline has been very modest, and investors shouldn't anchor to the high-water mark from a couple of weeks ago. It's more important to hold a portfolio you'll be comfortable with throughout an entire cycle.

Conclusion

It is already clear that 2020 will bring challenges, but there will also be opportunities. For example, the current decline in interest rates presents a future challenge for investment portfolios, but also an opportunity for refinancing mortgages and other debt. Well-constructed portfolios and financial plans create resilience and help us know when to act and when to be patient. It is in these periods of uncertainty and volatility that we are reminded why we go through the portfolio construction and planning process in the first place.

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