CREATIVE PLANNING

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Three Questions

Jonathan Clements
Director of Financial Education

When financial markets turn turbulent, you can count on two things: Investors start asking a ton of questions—and Wall Street pundits pretend to have all the answers.

The problem is, those answers are wrong half the time, because they're built on short-term market predictions. What's the alternative? Forget forecasting—and focus on first principles. Here are three questions that lots of folks are currently asking:

1. Why don't we put everything in cash and wait for the markets to settle down?

After three months of tumbling share prices, many investors are worried about further losses. If you're in that camp, there's one investment category you'll want to avoid: cash investments, like money market funds and savings accounts.

To be sure, if you have dollars you will need to spend soon, cash investments are often the only prudent choice. But they aren't a prudent long-term holding, because there's a high likelihood you will lose money, once inflation and taxes are figured in. Today, for instance, taxable money-market mutual funds are yielding an average 1.9%. That's below the 12-month inflation rate of 2.2%—and the shortfall would be even larger, once you hand over a slice of the interest you earn to Uncle Sam.

To make matters worse, swapping into cash investments could mean a big onetime financial hit. Let's say you shift money out of stocks that are sitting in a regular taxable account, and those stocks are worth twice what you paid. Assuming your capital-gains tax rate is 15%, the move from stocks to cash would trigger an immediate 7.5% loss to taxes.

2. If everybody knows interest rates are headed higher, shouldn't we sell bonds?

If you opt for bonds rather than cash investments, you gain a crucial advantage: You'll typically earn a yield that's higher than inflation, so you have a fighting chance of preserving the purchasing power of your money and perhaps even making it grow. But with that advantage also comes a disadvantage: Your bonds could suffer a short-term price drop if interest rates rise. And everybody knows interest rates are headed higher, right?

At this juncture, things get a tad confusing. Yes, the Federal Reserve has lately been raising interest rates and it's said that will likely continue in 2019, as it seeks to keep inflation in check. But remember, what the Fed controls is short-term interest rates. Those, in turn, help determine the rate you get on a savings account, short-term certificate of deposit or money-market account.

What if you own bonds? In that case, what you care about are longer-term interest rates, which are set by the market. If those rates rise, you would indeed see your bonds fall in price. But will longer-term rates rise, as is widely expected?

Here's the problem: In the financial markets, when people "know" something will happen, they don't tend to sit

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around and wait for the bulldozer to hit them. Instead, they act. What if "everybody knows"? That means lots of folks have acted—and there's a good chance that market prices already fully reflect investors' expectations.

Of course, we might get some new development—perhaps a surprisingly strong employment report or a surge in inflation—that drives interest rates even higher. Bad news for bond holders? Not necessarily.

In the short-term, you would see the price of your bonds drop. But it also means you can now reinvest your interest payments at higher yields. That higher reinvestment rate can help your returns far more than the initial price drop hurts. It's one of investing's most counterintuitive notions: If you're a bond investor with a reasonably long time horizon, you should be happy about rising interest rates, because you'll likely end up making more money.

3. Wouldn't it be smarter to wait for stocks to finish falling and then buy?

The stock market rises over time. The implication: Every day you sit in cash, waiting to buy stocks at lower prices, you're making a bet where the odds are against you. This is not sensible.

What's the alternative? You stay invested in stocks, so you don't miss out on the eventual market rebound—and you buy more if share prices fall further. Suppose you have 60% of your portfolio earmarked for stocks. If a market decline pushes that allocation below 60%, you should put more into stocks to get back to your 60% target.

This is rebalancing—the ultimate buy low-sell high strategy. Its success rests on two assumptions, neither of which would be considered controversial. First, the global economy, and hence corporate profits, will grow over the long haul. Second, that growth will eventually be reflected in higher stock prices.

That brings us to some good news: While share prices have gone nowhere in 2018, corporate profits have been going gangbusters, thanks in large part to last year's corporate tax cut. The good folks at S&P Global calculate that 2018's reported corporate profits for the S&P 500 companies will be 28% above 2017's level. That means that every dollar you invest today is not only buying shares at modestly lower prices, but also each share has a claim on significantly more corporate profits. Put those two things together, and stocks today are arguably 30% to 40% better value than they were a year ago.

That doesn't guarantee that share prices will climb next month or even next year. But eventually, investors will recognize the value that corporations have created—and those who stayed invested in the stock market will reap their reward.

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cpi@creativeplanning.com

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