MEDIA REVIEWS - April 28-30, 2020

There’s a pretty wide spectrum of articles from Advisor Perspectives this month, and I’m only hitting the highlights here. I’m going to direct your attention to the college funding article, which suggests that you can get a real bargain this year from the colleges, due to reduced income levels that will be listed on the FAFSA forms. Several articles look at how the markets or the economy could recover, sooner or later, from the pandemic shutdown, and Joe Tomlinson offers a different topic: the value (or lack thereof) of proposing bucket strategies for your investing clients.

Also, there’s an article by that Veres fellow, looking at how defensible your risk tolerance instrument would be in a court or arbitration hearing.

Please stay safe. If your clients are experiencing quarantine fatigue (aren’t we all?), help them know that they’re not alone, and that discomfort is preferable to serious illness.

Best,

Bob Veres
Inside Information
http://www.bobveres.com
Insider’s Forum conference - October 14-16, Austin, TX
http://www.insidersforum.com

The articles:

“Should You Buy a Medicare Plan from Joe Namath?”
by Joanne Giardini-Russell
Advisor Perspectives, April 1, 2020
https://www.advisorperspectives.com/articles/2020/04/01/should-you-buy-a-medicare-plan-from-joe-namath
Relevance: high
Your elderly clients are being targeted by a charming ex-jock who is telling them about an “excellent, free” Medicare plan that is not only free, but it adds in basic dental, vision and hearing care—plus a bathtub bar being installed, meal delivery and even transportation services. What’s not to like?

The article explains that this is a private insurance Medicare Advantage plan, not regular Medicare (you guessed that already), and it is not exactly free; clients still have to pay at least $144.60 a month ($1,735 a year) for their Part B coverage. And they have to pay co-pays. If you visit a specialist three times during the year, there is a copay of $40 each. If you spend time as an inpatient in the hospital, you pay $325 a
day. If you have physical therapy visits, each one costs $40. A bad diagnosis like cancer would create a maximum of $6,700 in out of pocket costs a year.

The bottom line is that this may be fine coverage for a healthy person, but elderly clients need to understand that there are risks to the zero premium Medicare option. Joe Namath isn’t telling the whole story.

“The Coronavirus Broke the Weighing Machine”
by Scott MacKillop
Advisor Perspectives, April 2020
https://www.advisorperspectives.com/articles/2020/04/06/the-coronavirus-broke-the-weighing-machine
Relevance: high
The author says that he, like many of you, is receiving a lot of messages from perma-bears who are claiming that they saw the recent market downturn coming all along, and others touting high-fee hedging strategies or diversifiers that have added no value for years, but performed really well in the month of March. He takes particular issue with the recent article by Bob Rodriguez, who has offered negative projections right through the long bull market, and claimed that the market was “at least 40% to 60% overvalued.”

MacKillop says that the markets are having trouble evaluating the value of future cash flows because we don’t know how the pandemic is going to impact most companies. Therefore, market sentiment is dominating right now, driven by news events. Sufficient data will become available at some point, and MacKillop is certain that stocks are not 10% less valuable one day to the next, as we experienced market drops of that magnitude. Patient investors will eventually be rewarded, since the fundamental underpinnings of the financial markets have not been obliterated.

“Stock Dividend Cuts Shouldn’t Worry Investors”
by Nir Kaissar
Advisor Perspectives, April 8, 2020
Relevance: high
Many advisors substituted dividend-paying stocks for the low-yielding bond alternatives when looking for income, and now they might be a bit worried as companies respond to this current economic crisis by cutting their dividends. The article looks at 10 market downturns since World War II (excluding the current one), and finds that dividends actually continued to grow in five of them. In four of the remaining five, the average cuts were 4%, and dividends were back to their previous highs, on average, in 2.5 years.

The one outlier is the 2008-9 downturn, when dividends were cut by an average of 25%. It took them four years to recover to their pre-crisis peak. The article notes that in that downturn, earnings per share for the S&P 500 fell 92%, much worse than what occurred during the Great Depression. Do we believe that a similar earnings recession will occur this time around?
Okay, but will lower dividends cause stock prices to decline further? During the bears markets since 1948, stock prices declined before dividends declined, which means that the bad news was built into prices before it happened. Today, it seems likely that investors have already paid the price for expected dividend declines.

“Investing in a COVID-19 MMT Era”
by John Balder
Advisor Perspectives, April 13, 2020
Relevance: high
The author says that even before the pandemic, the U.S. stock market was overvalued by most measures, and he blames a combination of Fed policies, stock buybacks and government deficits for pushing stock valuations to unsustainable levels. He points to longer-term trends like wage suppression and rising debt levels, and shorter term Fed actions, including lowering interest rates in 2019 when no recession was on the near horizon. A chart shows stock buybacks soaring since 2009 while cumulative flows into equities remained roughly flat.

But what now? The author admits that we are in uncharted territory, notes the astounding number of initial unemployment claims, and predicts that the Fed balance sheet will cross the $10 trillion mark within the next 12 months. Until this year, the Fed’s focus was on assisting banks and the financial sector, rather than individuals. Total debt outstanding in the world has grown to $253 trillion, or 323% of global GDP. At the end, the author admits the the impact of the support packages, current and future, could be deflationary or inflationary. He warns against head-fakes in the market that look like the start of another bull, noting that in the Great Depression there were several impressive runups followed by more-than-impressive declines.

“Financing College Education When a Recession Hits”
by Paul Hill and Michael Havis
Advisor Perspectives, April 13, 2020
https://www.advisorperspectives.com/articles/2020/04/13/financing-college-education-when-a-recession-hits
Relevance: high
This is interesting. The co-founders of Educate to Career, a nonprofit specializing in college planning data, say that this is an ideal time to send your kid to college. Not physically on campus quite yet; you apply at a time when your youngster might have trouble getting a job anyway, and your reduced income during the downturn works to your advantage when you fill out the FAFSA form. Your expected family contribution might have been $13,000 at a moderately expensive college when your income was $200,000. If it has fallen (hopefully temporarily) to $49,000, that same college cost will drop to under $5,000. You’re buying at the bottom. (Educate to Career has a database which shows college admissions pricing and can show the probability of admissions to different schools.)
The article talks about what a bargain two-year colleges are (and the credits apply to four-year schools) and recommends substantive degrees like business, engineering and healthcare. It says that at the very expensive private and top state colleges, a 3.8 GPA student can get in, and the private colleges are now negotiating more than they ever have before, doling out “institutional” aid that reduces net tuitions by up to 70%. Moderately selective state colleges are selecting students with 3.5 GPAs and above, and they are, we are told, a great value.

The bottom line, pretty much everywhere in the U.S., a client’s child can be enrolled for less than $10,000 a year at a four-year public college, and if the family has suffered a (hopefully temporary) job loss, that tuition bill could drop to $5,000. It’s a nonintuitive thing to bring up to client families.

“Thinking Outside of the V-Shaped Recovery Box”
by Michael Lebowitz
Advisor Perspectives, April 13, 2020
Relevance: high
The purpose of this article is to help us think about the future—in two parts. Part one is the short term—that is, the inevitable economic recovery from this pandemic-induced recession. The author tells us that seldom are significant, life-altering events followed by a quick return to normality—and advises us against expecting the V-shaped recovery that so many economists are predicting. Sure, if we get a full-fledged cure and a vaccine is developed, then everybody will be able to return to work and their lifestyles will look much like they did before. But what are the odds that one or the other won’t take a year to develop? Will people be willing to go back to crowded restaurants, attend sporting events, ride the planes or subway? The economic recovery might be gradual, and we should prepare for that likelihood.

Okay, what about the long-term impact? Here we might see behavioral change, as people truly absorb the lesson that saving for a rainy day is not just a slogan, but a survival strategy. People who suffer through the Great Depression were more frugal than people who came of age during more prosperous times. Will people who live through this pandemic be more cautious about how they save, invest and spend? Will they want more cash in their portfolios, and more transparency about the companies they invest in? Seems likely.

“Bucket Strategies - Challenging Previous Research”
by Joe Tomlinson
Advisor Perspectives, April 20, 2020
https://www.advisorperspectives.com/articles/2020/04/20/bucket-strategies-challenging-previous-research
Relevance: high
The bucket strategy—specifically having a couple of years of expenses set aside in cash—was a big winner during the downturn earlier this year, because it helped keep...
clients from panicking. This article wonders if bucket strategies provide a financial benefit, in addition to the behavioral benefits.

Tomlinson is a diligent and intelligent researcher, and he focuses here on withdrawal sequences, and then narrows the focus to the worst 30-year scenario in the Bengen research—and in a bucket strategy analysis by Profession Javier Estrada that did a similar evaluation of 4% initial and ongoing (inflation-indexed) withdrawal strategies. This worst-case scenario has a retiree leaving work and starting distributions in 1966. Stocks lost approximately 70% of their inflation-adjusted value from 1966 to 1982.

The rules were simple: when the markets were up, money came out of the regular portfolio. When the markets were down, the hypothetical retire took living expenses out of the cash bucket instead, which would be replenished when the markets recovered.

Compared with a constantly-rebalanced 60/40 allocation, two different bucket strategies underperformed; that is, they ran out of money after 24.7 and 26.1 years during this difficult time period. Having two years of cash reserves was less efficient than having a moderate allocation to stocks. (Also of note: the author assumed a 1% annual return on cash, but this was a time period when cash was delivering up to double digit returns. Would that have made a big difference?)

A Monte Carlo analysis assuming stocks produce a real annual return of 5% with a 20% standard deviation (again assuming a 1% fixed return for cash), produced more varied results. The 2-year cash bucket strategy showed a slightly higher failure rate than the 60/40 allocation or a 60/40 allocation with a 2-year cash bucket allocation, but really all the results had approximately the same 30-35% failure rates.

Conclusion: a bucket strategy is really equivalent to an asset allocation strategy where the investment mix varies slightly from year to year. It doesn’t produce superior returns, but it doesn’t seem to have a significantly deleterious impact on client outcomes either.

“Money Management for Female Professionals During the Pandemic”
by Bridget Venus Grimes
Advisor Perspectives, April 21, 2020
Relevance: high
An advisor who works with women attorneys recommends that, in addition to the big picture asset management services you offer, you also get into the weeds of a client’s financial life during the pandemic. If their income is impacted (and whose isn’t?) then help them think about what a conservative income might look like this year, and go through expenses. Which of them must be paid, vs. those that are nonessential. Focus on conserving capital. They can defer mortgage payments and federal student loans, which helps with cash flow, and in extreme circumstances they may need to dial back (or eliminate) their 401(k) contributions temporarily. Advise clients to resist the temptation to use credit cards to cover the financial gap.
This may be the time to tap into their emergency fund, but if they have sufficient income, it is also a good time to build up their reserves to cover at least three months of fixed expenses. Also: look at alternative sources of income, if available. Help clients resist the temptation to move to cash, and if they are taking withdrawals, help them reduce the amount of withdrawals through the aforementioned budgeting advice.

“How Negative Interest Rates Pervert Investment Decisions”
by Larry Swedroe
Advisor Perspectives, April 22, 2020
https://www.advisorperspectives.com/articles/2020/04/22/how-negative-interest-rates-pervert-investment-decisions
Relevance: high
On March 25 of this year, the yield on three-month Treasury bills fell to -0.08%. Swedroe unnecessarily tells us that investors buying those instruments will be locking in a guaranteed loss. How will that impact investor behavior?

An article in the January 2020 issue of Finance Research Letters asked 316 students to allocate an experimental endowment of 60,000 monetary units between a risk-free and a risky asset over one years and ten years. The authors found that when the risk-free rate was above 0%, the average share invested in risk assets was consistently around 50%. But when the risk-free rate was negative, the risk-taking increased significantly, to 61% of the portfolio. Participants with strong loss avoidance overweighted their portfolio in risk assets by a greater percentage. Risk-taking increases if the interest rates turn negative.

“A Bold Solution for the Post-COVID Recovery”
by John Balder
Advisor Perspectives, April 27, 2020
https://www.advisorperspectives.com/articles/2020/04/27/a-bold-solution-for-the-post-covid-recovery
Relevance: high
A global strategist with Wellesley Investment Partners, who once worked with the U.S. Treasury and the Federal Reserve Bank of New York, is basically arguing here that the government needs to create another New Deal to restore the American economy, not just to where it was before the pandemic, but to the shared prosperity that followed world War II. He notes that the fragile, tentative recovery from the Great Recession was due to the weakened balance sheets of the middle class and rapidly growing income and net worth inequality in the U.S. A graph shows that income inequality had declined from around 1943 to around 1985, then rose steadily thereafter. He notes in passing that the government can create financial resources at a whim, and then shows the social benefits of the New Deal, when the government employed 60% of the unemployed in public works and conservation projects.

These projects planted a billion trees, modernized rural America, built New York’s Lincoln tunnel and Triborough Bridge complex, crated the Tennessee Valley Authority,
and built or renovated 2,500 hospitals, 45,000 schools, 13,000 parks and playgrounds, 7,800 bridges, 700,000 miles of roads and a thousand airfields.

What followed, of course, was a political disdain for government as a solution to any problem, and a shift toward “free markets.” Organized labor was marginalized, the government lifted Depression-era constraints on the financial markets, households borrowed to supplement stagnant incomes, and financial sector profits as a share of total corporate profits increased from an average of 10-15% during the 1960s to 40% in 2001-2, before the financialized framework collapsed in the 2007-8 global financial crisis. The government stepped in to support the banks—which, the author notes, is not how free markets are supposed to work. Since then, speculative financial activities have moved from the banking system into shadow banking institutions.

The author says that the government should restructure the financial system as it did in the 1930s and prevent financial institutions from engaging in speculation—channeling capital into productive activities. Government hiring and government financing of productive projects, the author argues, should be reinstated, but cautiously, not wastefully as under the current CARES Act, where undeserving (but politically-connected) firms are feeding at the public trough. If we are to have a new new deal, we need to change the culture in Washington, and find a way to make politicians care about creating a more stable, more prosperous economic system that leads to shared prosperity, not just for the one percent, but for the middle class as well.

“A Comparison of Risk Tolerance Products”
by Bob Veres
Advisor Perspectives, April 27, 2020
Relevance: high
Bear markets like this one (does anybody think the markets will only go up from here?) tend to produce the occasional disgruntled client, who will take you to arbitration in hopes of forcing you to reach into your own pocket and make him/her whole. The charge will be that you recommended unsuitable investments, and your best defense is the risk tolerance quiz you administered to find out the client’s preferences before the investment process.

The question here is: how would you defend the methodology of the risk tolerance instrument you used, from a scientific basis, if it was challenged by the plaintiff attorney in arbitration? The author asked several risk tolerance companies to provide the scientific justification for their assessments.

Results? FinaMetrica provided a 41-page technical manual co-authored by a research fellow at the London School of Economics discussing the normative distribution of nearly 550,000 scores collected across four continents, plus 250 research reports in prestigious journals, plus a way to capture the results of the client conversation about risk and return. It got an A+ score for defensability.
Riskalyze, the U.S. market leader, provided a 2015 research paper that it commissioned, authored by three Ph.D.s and another researcher which has not been published in any journal. The authors discuss the methodology and actually proposed better alternatives to it. The defensibility is mostly around having records of your conversations with a client after he/she took the test. Score: C.

Tolerisk Pro not only assesses a client’s risk tolerance but also the risk capacity, on the theory that, no matter how bravely the client dives into the markets, the actual financial situation should play a role in determining the recommended portfolio. The company sent a white paper which shows the output for a hypothetical client, the “willingness” and “ability” scores, and the client acknowledges with a signature that he or she has read and understands the contents of the report. The program gets points for the additional risk capacity assessment and gets a score of C+.

Totum Risk also measures risk tolerance and risk capacity, leaning heavily on the latter. The methodology, according to the website, was built by Ph.D.s, but the documentation was sparse and the company didn’t produce anything additional. Defensibility score: C-.

Andes Wealth Technologies offers a simpler risk tolerance measure: the client can see your model portfolios, arranged from lowest to highest risk, with returns and potential downside graphically illustrated out to two standard deviations. The client can see a variety of time frames, which offers a more thorough sense of risk tolerance, and then can decide which portfolio is best suited to him/her. Another aspect: Andes will also evaluate whether the current portfolio is efficient, meaning how close is it to the efficient frontier? This addresses a weakness of the other instruments: you might adjust the portfolio to match the client’s risk tolerance but end up proposing an inefficient mix of assets.

Andes Wealth is supported by any documentation that also supports Modern Portfolio Theory and the distribution of returns—and also, of course, it captures the gist of your conversation with a client surrounding the decision of which portfolio to invest in. Score is slightly below FinaMetrica’s voluminous academic justification: B+.

It should be noted that this is NOT an evaluation of the quality of the programs themselves: only how confident you should be if you were to try to defend your risk tolerance methodology in court or arbitration.