

Seen your Shadow?

April 2020

Every year in February, the public anxiously watches on Groundhog's Day as Punxsutawney Phil (yes the groundhog) tries to find his shadow. If he sees it, then six more weeks of winter are ahead of us. If he can't see his shadow, then early spring awaits. As you would expect, the groundhog's record of predictability is poor at best. However, our feelings are nonetheless affected on the results. "Groundhog didn't see his shadow. YES, early spring!"

Yesterday certainly had that Groundhog's Day feeling. Wisconsin Governor Evers issued the stay-at-home order for another six weeks. A collective sigh was heard throughout the state. We are unsure if we can make another six weeks like this. To make light of a difficult situation, apparently Governor Evers saw his shadow.

Over this past month, life has felt similar to being in the Groundhog Day movie. For those that have not seen the movie, Bill Murray's character experiences the same day over and over again. Every day is similar to the last until he figures out the remedy. Not being able to leave the house has made each day seem very similar to the last.

I start with these analogies because the stay-at-home order and social distancing has about the same predictive results as Phil seeing his shadow. No one knows for sure whether this is the right amount of time. We may never know. It's a guess and the future is uncertain.

Living with Uncertainty

The recent debate about stopping the spread of COVID-19 brought me back to an example behavioral economists have used for years to describe computational shortcuts taken to address complex problems.

The situation is this: Experts tell a group that 600 people will die of disease if nothing is done. They offer two contingencies to deal with the issue. Under Option A, 200 people will be saved. Under Option B, there is 1/3 probability that all 600 people will be saved and 2/3 probability that everybody will die. Given these choices, people overwhelmingly choose Option A. Following the math, Option A and B are computationally the same.

Experts then present identical situation, but in revised way to different group. Under Option C, 400 people will die. Under Option D, there is 1/3 probability that nobody will die and 2/3 probability that 600 people will die. This group prefers Option D. Again, following the math, Option C and D are the same (and also the same as Option A and B). The difference was in framing and one option was certain and the other was not.

How do behavioral economists account for opposing responses to identical choices and probabilities? The answer is humans have difficulty dealing with uncertainty. In making choices and decisions, we overweight certain outcomes to uncertain outcomes, even when uncertain outcomes have high probability. Armed with this knowledge it is interesting to see how we arrive at initial decisions.

Investing with Uncertainty

Investing is a bet on an uncertain future. If it were certain, the returns would be no different than your checking account interest. Risk would be low and return would be low. This is not something new. However, it becomes much harder to deal with when living through “bad” uncertain times. Our minds can be quickly hijacked by the current feelings we are experiencing and by opinions we are hearing from others. This is the normal human response and is to be expected. It makes sense why behavioral economists see what they do in their research. However, what separates long-term investor performance is what happens next.

If the immediate reaction is to take the certain thing when uncertainty is at its peak even though your goals have not changed, then you may be disappointed in your long-term results. If your situation has changed or goals have changed, then certainly revisiting investment allocation is prudent thing to do regardless of economic uncertainty. Loss of job or desire to be free of debt being some examples.

Capital allocation

We spoke briefly in our last newsletter regarding the role of government in our investing strategy. We think this is important topic that is worth addressing.

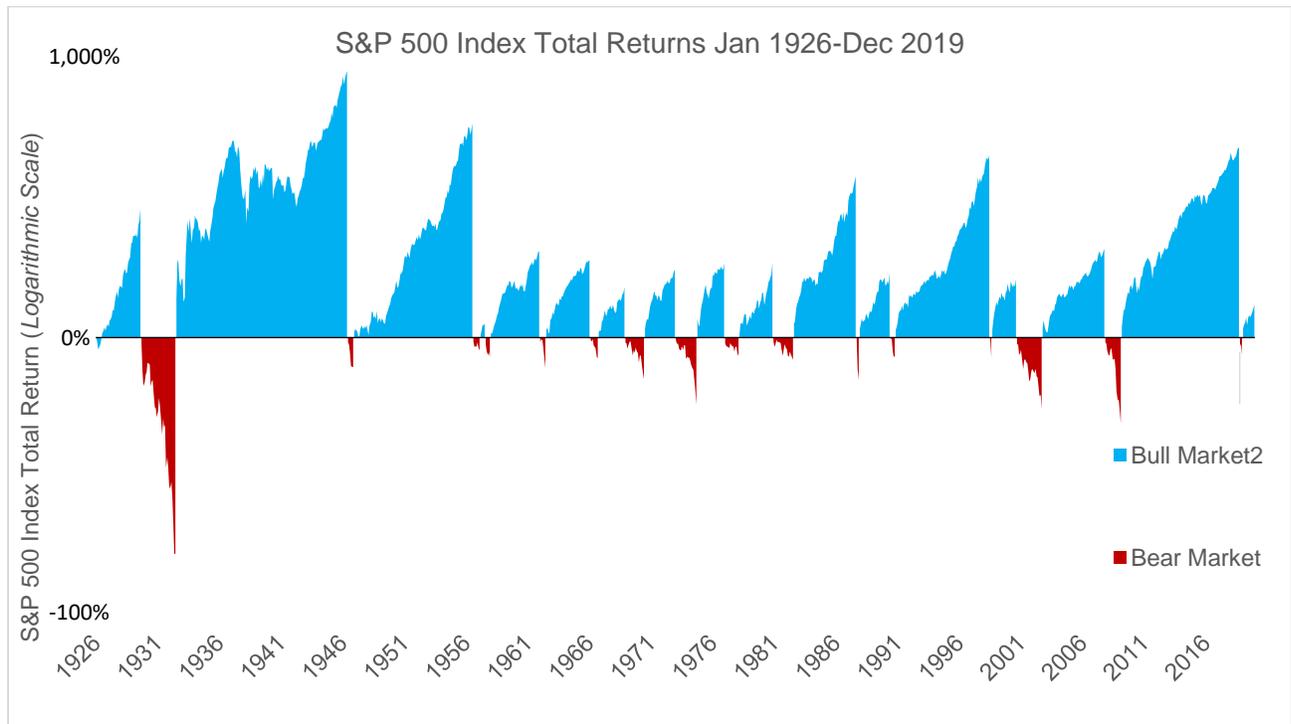
During highly uncertain times, people will begin trying to compare the current situation with a previous point in time. Having access to droves of research, they will eventually find what they are looking for. The great thing about the past, you know how the story ends. Unfortunately, the more specific you get about predicting a past event looking like current event, the more disappointed you may become. The reason is people are making adjustments based on those past events. No one wants to make the same mistake as the past, so they will adjust their behavior.

Here are a few specific additional insights on this concept. Every major downturn will undoubtedly be compared to the Great Depression. It’s well known even today and it elicits an emotional response. Not hard to see why people use that as reference! However, we place the probability of another Great Depression as being very low. The simple reason is government learned that primary driver of that event was caused from lack of liquidity. The access to money was very difficult for everyone which made a bad situation worse.

Thus, government officials know that in stressful times they need to be the backstop for the economy. Whether that is through supporting financial markets via the Federal Reserve or providing fiscal stimulus through government disbursements, the government understands its importance in preventing another Great Depression. We saw this in the Great Recession in 2008. We are seeing it play out again in 2020. People can rightfully argue about the amounts, the timing, and the recipients, but we think arguing about its probability of happening in stressful times is not a winning strategy. Regardless of what people think of politicians, selfishly they will choose printing more money over experiencing a long Depression. Depressions are certainly not a way to win re-election.

History of Market

We spend time on the economic fundamentals because those concepts help broadly explain why market returns have happened. The blue lines do not just magically happen. It's the underlying individual companies, employees, and governments working towards better futures. Through that lens, investors can begin to understand the "why" behind the charts results below.



Bear markets are defined as downturns of 10% of greater from new index highs. Bull markets are subsequent rises following the bear market trough through the next new market high. The chart shows bear markets and bull markets, the number of months they lasted and the associated cumulative performance for each market period. Results for different time periods could differ from the results shown.

Past performance is no guarantee of future results. Indices are not available for direct investment; therefore, their performance does not reflect the expenses associated with the management of an actual portfolio.

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Staying positive

Some days it's hard to find many things to be positive about. However, it is in these moments when true leadership and friendship are seen. Being there for someone else or simply reaching out to someone you know will answer your call is extremely important. I speak for the team when I say we have been thankful to be on both sides of those calls. Thank you for your continued trust and we will get through this together.