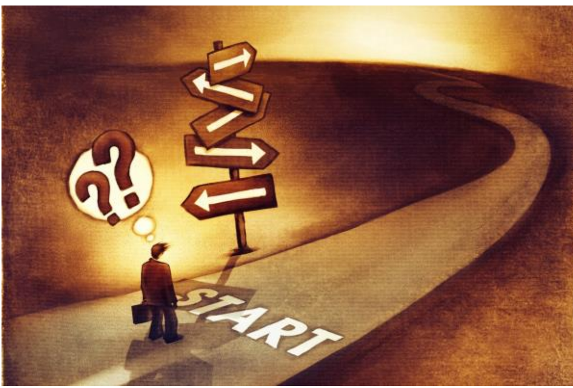
The Uncertainty Paradox

"The market hates uncertainty" has been a common enough saying in recent years, but how logical is it? There are many different aspects to uncertainty, some that can be measured and some that cannot. Uncertainty is an unchangeable condition of existence. Rather than ebbing and flowing with investor sentiment, **uncertainty is an inherent and ever-present part of investing in markets**. Any investment that has an expected return above the prevailing "risk-free rate" (think T-Bills for US investors) involves trading off certainty for a potentially increased return.



Consider this concept through the lens of stock vs. bond investments. Stocks have higher expected returns than bonds do, largely because there is more uncertainty about the future state of the world for equity investors than for bond investors.

Bonds, for the most part, have fixed coupon payments and a maturity date at which principal is expected to be repaid. Stocks have neither. Bonds also sit higher in a company's capital structure. In the event a firm goes bust, bondholders are paid before stockholders are. So, do investors avoid stocks in favor of bonds because of this increased uncertainty? Quite the contrary—investors end up allocating capital to stocks due to their higher expected return. In the end, many investors are often willing to make the trade-off of bearing some increased uncertainty for potentially higher returns.

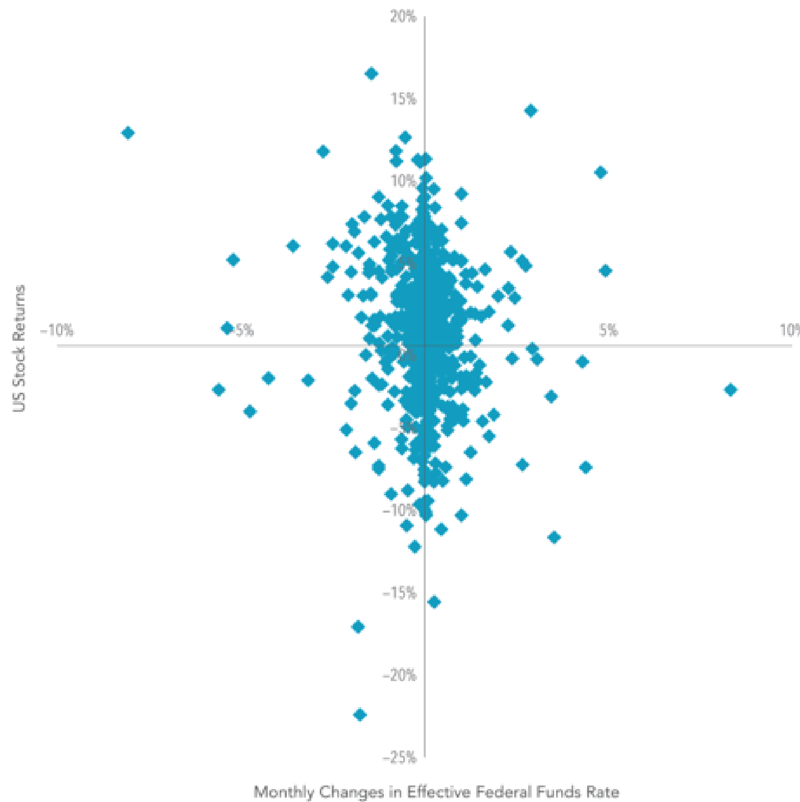
While the statement "The market hates uncertainty" may not be totally logical, that doesn't mean it lacks educational value. Thinking about what the statement is expressing allows us to gain insight into our mindsets. The statement attempts to personify the market by ascribing the very real nervousness and fear felt by many investors when volatility increases. It is recognition of the fact that when markets go up and down, it can be a struggle to separate emotions from investments. It ultimately tells us that for many, regardless of whether markets are reaching new highs or declining, changes in market prices can be a source of anxiety. During these periods, it may not feel like a good time to invest. Only with the benefit of hindsight do investors feel as if they know whether any time was a good one to invest. Unfortunately, while the past may be a prologue, the future will forever remain uncertain.

People often wonder, "How long do I have to wait for an investment strategy to pay off? How long do I have to wait so I'm confident that stocks will have a higher return than money market funds, or have a positive return?" And the answer is—it's at least one year longer than you're willing to give. There is no magic number. Risk is always there.

Part of being able to stay unemotional during periods when it feels like uncertainty has increased is having an appropriate asset allocation that is in line with your goals and time horizon. It helps to remember that, during what feels like good times and bad, one wouldn't expect to earn a higher return without taking on some form of risk. While a decline in markets may not feel good, having a portfolio you are comfortable with, understanding that uncertainty is part of investing, and **sticking to a plan that is agreed upon in advance and reviewed on a regular basis** can help keep emotional (over)reactions at bay, and ultimately lead to a better experience.

When Rates Go Up, Do Stocks Go Down?

Exhibit 1. Monthly US Stock Returns against Monthly Changes in Effective Federal Funds Rate, August 1954–December 2016



Monthly US stock returns are defined as the monthly return of the Fama/French Total US Market Index and are compared to contemporaneous monthly changes in the effective federal funds rate. Bond yield changes are obtained from the Federal Reserve Bank of St. Louis.

Evidence shows that, like stock prices, changes in interest rates and bond prices are largely unpredictable. It follows that an investment strategy based on attempting to exploit these sorts of changes isn't likely to be a fruitful endeavor. Despite the unpredictable nature of interest rate changes, investors may still be curious about what might happen to stocks if interest rates go up.

Unlike bond prices, which tend to go down when yields go up, stock prices might rise or fall with changes in interest rates. For stocks, it can go either way because a stock's price depends on both future cash flows to investors and the discount rate applied to those expected cash flows. When interest rates rise, the discount rate may increase, which in turn could cause the price of the stock to fall. However, it is also possible that when interest rates change, expectations about future cash flows expected from holding a stock also change. So, if theory doesn't tell us what the overall effect should be, the next question is what does the data say?

Recent research provides insight into this question by examining the relationship between monthly US stock returns and changes in interest rates.[1] Exhibit 1 shows that while there is a lot of noise in stock returns and no clear pattern, not

1. US stock market defined as Fama/French Total US Market Index.

much of that variation appears to be related to changes in the effective federal funds rate (the interest rate at which depository institutions lend funds maintained at the Federal Reserve to another depository institution overnight).

For example, in months when the federal funds rate rose, stock returns were as low as –15.56% and as high as 14.27%. In months when rates fell, returns ranged from –22.41% to 16.52%. Given that there are many other interest rates besides just the federal funds rate, researchers also examined longer-term interest rates and found similar results.

To address our initial question: when rates go up, do stock prices go down? The answer is yes, but only about 40% of the time. In the remaining 60% of months, stock returns were positive. This split between positive and negative returns was about the same when examining all months, not just those in which rates went up. In other words, **there is not a clear link between stock returns and interest rate changes**.

There's no evidence that investors can reliably predict changes in interest rates. Even with perfect knowledge of what will happen with future interest rate changes, this information provides little guidance about subsequent stock returns. Instead, staying invested and avoiding the temptation to make changes based on short-term predictions may increase the likelihood of consistently capturing what the stock market offers.

Of Presidents and Other Irrelevancies

What follows is, I solemnly assure the reader, NOT a political statement of any kind. Instead, it will turn out to be a rather impassioned defense of the thesis that the peregrinations of government in general, and **the antics of presidents have historically been distractions at worst—and perfect irrelevancies rightly considered—to the patient, disciplined, goal-focused, long-term investor**.

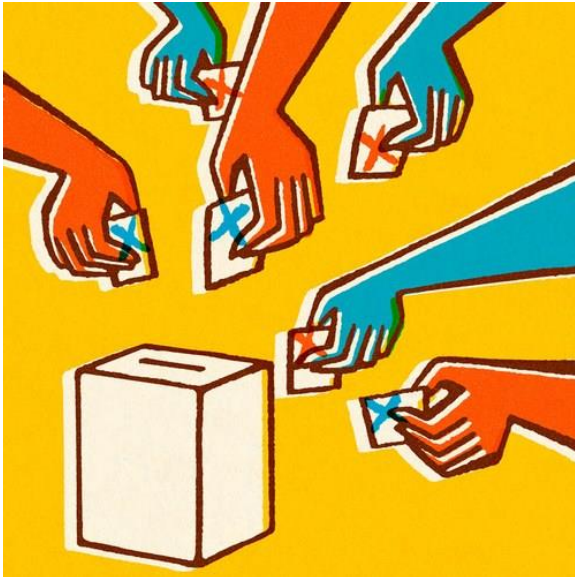
It will, however, refer at greater or lesser length to Presidents Trump, Carter, Nixon, Clinton and Obama, in that order. If the reader is at all inclined to become choleric at the mention of any of these gentlemen, he/she may wish to leave off reading. Please consider this fair warning. It will be noted that our national conversation is currently, and one may even say morbidly, fixated on the actions, attitudes, policies and yes, even tweets, of President Trump. There has lately been—and I will venture to speculate that there may yet again be—concern among investors that his behavior is impacting the values of, say, five hundred of the world's larger, more financially sound companies (commonly referred to collectively as "the stock market").

Parse him how you will, President Trump may, I think, be fairly characterized as an outsider who was elected to the presidency to "drain the swamp," as the phrase is. Instead, many question whether he has run afoul of his own and his staff's inexperience. I will ask you calmly to consider that this is exactly what was being observed forty years earlier to the day about President James Earl Carter, Jr.

There is, however, one anecdotal comparison one might make between the early months of both presidents. And I suggest that it is a juxtaposition to which the long-term investor would be well advised to pay attention. To wit: On the hundredth day of the Trump administration, the Standard & Poor's 500-Stock Index closed at about 2,400. Forty years earlier, on the hundredth day of President Carter's one term, it closed at 100. (A little gentle rounding has been used here for effect; be assured that it does no violence either to the facts or to their implications.)

Now, I think friend and foe alike would allow that President Carter's term was, on balance, ultimately unsuccessful. It encompassed the second of two huge oil shocks, runaway inflation,

a deep recession and—as he himself suggested, though not in this word—a pervasive national malaise. Friend and foe alike will similarly allow that the early indications on a Trump administration are unclear. **But that is to miss the point**.



Which is, of course, that if you liquidated your long-term equity investments in 1977 in response to what you perceived as a presidency that appeared headed for disaster, you missed all or some part of one of the great accretions of equity values in history.

This realization might prompt one to look back over the unmitigated presidential/governmental crises of one's lifetime—for crises they surely were—and then to examine the subsequent behavior of the equity market. To cite but a few of the more extreme examples:

On Saturday night, October 20, 1973, President Nixon ordered the firing of the Watergate special prosecutor, Archibald Cox, and the abolition of his office. The attorney general declined to carry out this heinous order and resigned, as did his second-in-command. The solicitor general ultimately executed the order as acting attorney general and thus precipitated what may have been the gravest constitutional crisis in American history. On the following Monday, the S&P 500 closed at 109.

On December 19, 1998—oddly, also a Saturday—the U.S. House of Representatives voted to begin impeachment proceedings against President Clinton, on charges of perjury and obstruction of justice. On the following Monday, the S&P 500 closed at 1,203.

On October 1, 2013—after months of the most distressing brinkmanship between Congress and President Obama—the U.S. government shut down for want of an agreement on the funding of it. We had been assured all along that this unthinkable eventuality would have the most apocalyptic consequences: The United States would default on its debt, because interest wouldn't be paid and maturing bonds couldn't be redeemed or rolled over; our brave men and women in uniform would go without their salaries; and Grandma would starve to death in the dark because her Social Security check would not arrive. On that fateful first day of the shutdown, the S&P closed at 1,695.

As I write, the S&P 500 has closed, however tentatively, above 2,400. Raise your hand if you're beginning to see a pattern here. Dear reader, I suggest that these anecdotes, taken together, testify to the genius of the American economic system. What they say to me—and what I now say to you—is that if history is any guide, rational capital ultimately outlasts irrational presidencies. And that **fleeing the capital markets in reaction to distressing political events has in the past never proven to be a lastingly successful investment policy**.

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