Worried About the Election and Your Portfolio? Don't Be.

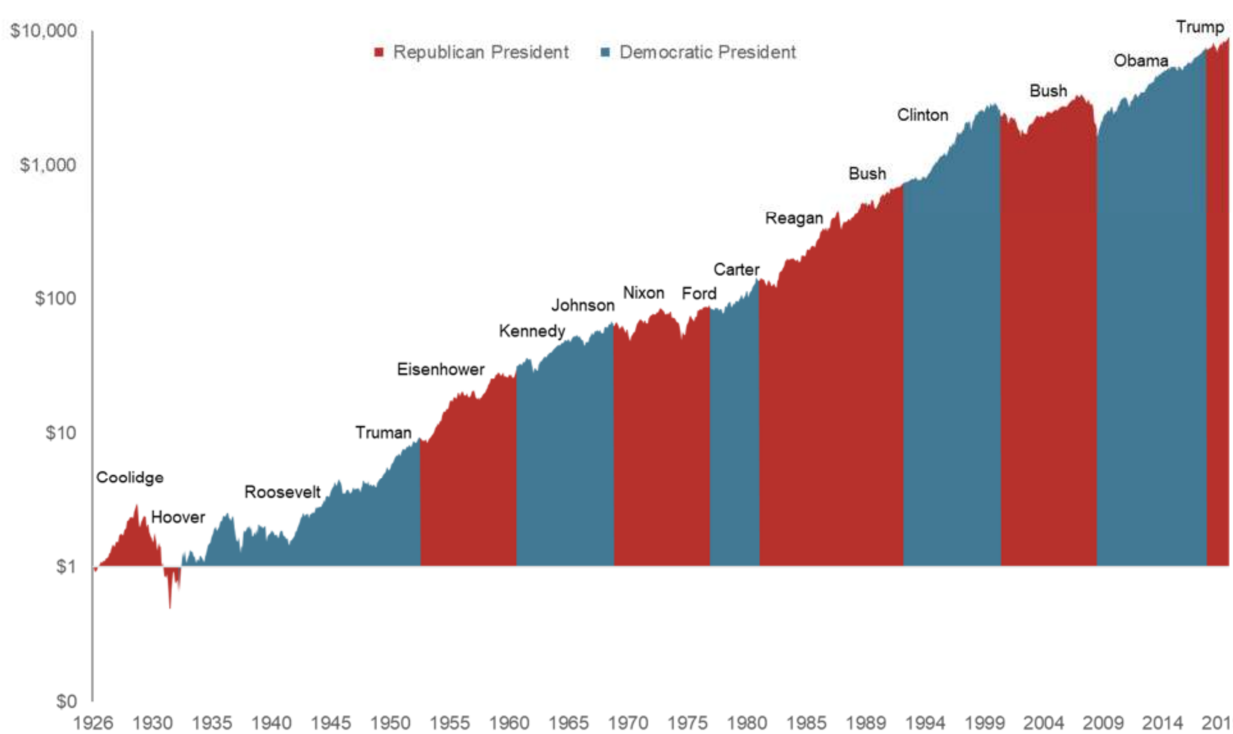
Investing amid uncertainty can be a challenge for even the most seasoned investor. 2020 is no exception, and in fact it seems as if the stakes are even higher with a global pandemic, an economy still reeling, incredibly partisan presidential and congressional elections – just to name a few of the highlights of the year. But as investors, it is important as always to stay the course and to be reminded of the relentless long-term trajectory of markets.

Hopefully, some historical data will help put this into perspective. Quite frankly, the market doesn't care who wins the White House. It's nearly impossible to identify any systematic return patterns in election years. ***Figure 1*** shows that $1 invested in 1926 would be worth almost $10,000 as of the end of 2019, participating in a general upward market trend through both Republican and Democratic presidencies.

"But what about volatility in election years?" you ask. "Would I be better served holding cash on the sidelines until after the craziness of election season and investing it once we know the outcome?" It's a valid thought, but once again, data points to the contrary. The Capital Group recently did such an analysis and found that sitting on the sidelines in election cycles had by far the worst outcome when compared to lump-sum investing or dollar-cost averaging strategies.

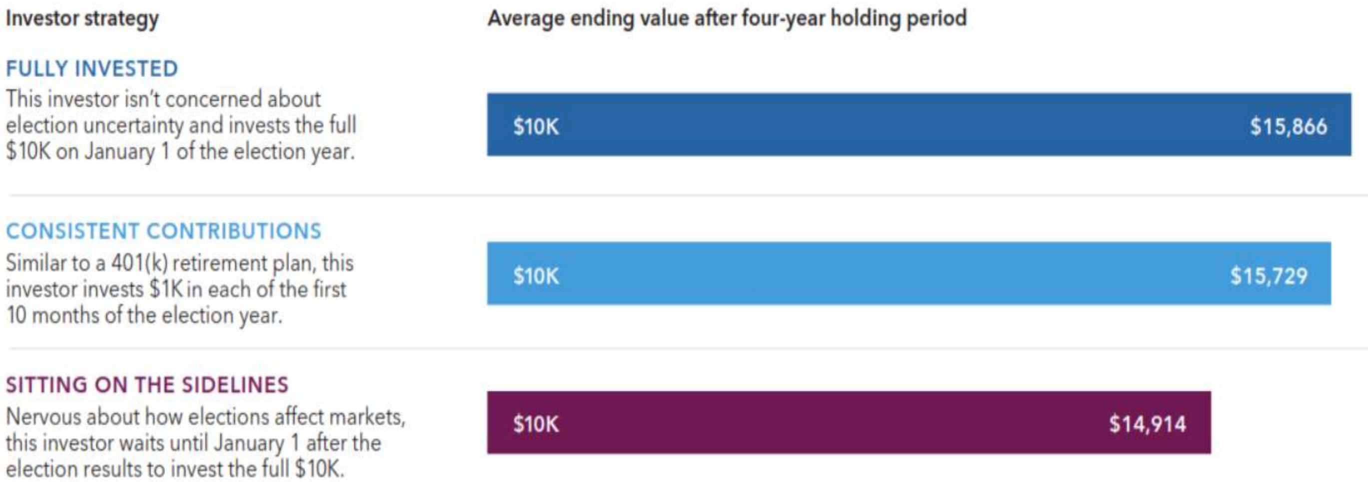
Figure 2 (next page) shows that waiting until after an election to invest cash resulted in the lowest average ending value of the initial investment. Further, when looking at the 22 election cycles going back to 1932, waiting on the sidelines had the worst outcome in 16 of 22 cycles, while it was the best performer in only three cycles. Interestingly, the average ending value between the fully invested (lump-sum) and consistent contributions (dollar-cost averaging) strategies is minuscule. The message is clear: Investing and staying disciplined even when the news is scary, is the right strategy.

Figure 1: Markets Have Rewarded Long-Term Investors under a Variety of Presidents



Source: Dimensional Fund Advisors.

Figure 2: Three Hypothetical $10K Investment Strategies during an Election Cycle



Sources: Capital Group, Morningstar, Standard & Poor's. The three hypothetical investors each have $10K to invest during an election cycle and are invested in a combination of equities and cash at all times. ***Fully Invested*** *is always fully invested in equities.* ***Consistent Contributions*** *starts with $1K in equity and $9K in cash. At the start of each of the next nine months, this investor reduces cash by $1K and makes a $1K contribution to equities, after which they will have made the full $10K contribution to equities.* ***Sitting on the Sidelines*** *is entirely invested in cash during the first year. At the start of the second year, this investor reduces cash by $10K and makes a $10K contribution to equities. Analysis starts on January 1 of each election year and reflects a four-year holding period.*

Wait…a 97% Loss???

Well-known journalist Brett Arends recounted an alarming recurrence last month, one brought about by the New York Subway pension losing over $300 million in a collapsed hedge fund. We've sourced much of the data in this article from his work, so all credit to Brett for his efforts here.

Why do pension funds keep doing it? Why do pension fund trustees keep falling for one of the oldest games in the business?

The $4.8 billion pension fund of New York's Metropolitan Transportation Authority just became the latest to sue a hedge-fund manager after losing hundreds of millions of dollars in complicated financial vehicles that maybe nobody could understand.

The MTA joins a list of anguished pension trustees suing German financial giant Allianz over its "Structured Alpha" funds, which collapsed in the market turmoil earlier this year **wiping out 97%—yes, really**—of investors' capital.

Others suing Allianz are the Blue Cross Blue Shield National Retirement Trust, Lehigh University, the Arkansas' Teacher Retirement, and the Teamsters. More will undoubtedly follow. Blue Cross Blue Shield says it had $2.9 billion in the fund at the start of the year and suffered "staggering" losses. Lehigh had $62 million in the fund. The Arkansas teachers lost an astonishing $774 million.

BlueCross BlueShield

Oh, and for the kicker: The pension fund trustees say in their complaint that the hedge fund was sold to them as an "all-weather" fund. Oops… evidently not.

For its part, Allianz issued a statement denying any wrongdoing. The pension funds have all filed long and detailed complaints with the courts, trying to explain how Allianz was "negligent" and "imprudent" in the complicated derivatives strategy it pursued, the way it executed, or both.

But there's a simpler question to ask. Regardless of whether or not the managers of Allianz Structured Alpha portfolios were following their own promised strategy, what on Earth are these pension fund managers doing investing in these hedge funds anyway? Taking risks like that with your pension holders' money seems… well, quite ridiculous.

Statistically speaking, hedge funds are a terrible investment. Absolutely terrible. The few funds that supposedly know how to beat the market have little incentive to invite outside investors because, well, why would they? If I know how to beat the market by a wide margin every year, why on Earth would I go around giving my profits away to other people? Renaissance Technologies' Medallion Fund, the long-ballyhooed superstar of hedge funds, hasn't wanted to take investor money in 30 years.

It's really not that complicated. Most hedge funds are brilliant vehicles designed to make their managers rich. That doesn't mean they're doing anything illegal, or maybe even unethical. It's wanton capitalism. It just means they're generally a terrible investment, like a new car or a $30,000 handbag. Only with hedge funds, you don't even get the car or the bag.

Consider this: A sleepy, balanced portfolio of 60% U.S. stocks and 40% Treasury bonds has typically earned investors about 8% a year, on average, going back to the 1920s. A hedge-fund manager who charges the industry's typical high fees—often 2% a year plus 20% of the profits—would have to make about 11.5% a year gross just for you to do as well after fees. In other words, as an investor, you're not going to get ahead of the game at all in the average hedge fund unless the managers can beat the market by about 50% every year. Seriously? You think someone can beat the market by more than 50% a year and they're going to cut you in?

Industry numbers substantiate this intuition. Meanwhile, how have hedge-fund investors fared so far this year? They were actually down 3.7% through Aug. 31, according to Hedge Fund Research, which tracks the numbers. That's the asset-weighted average return. And that's not just since January. The picture is the same over one year or five. The average hedge fund investment has done worse, much worse, net of fees than pretty much any basic portfolio you care to mention.

But maybe the best measure of all is to look at what would have happened if hedge-fund investors had just shown Wall Street the door and instead randomly picked stocks themselves, not just in the U.S. but around the world.

Over the past five years, through Aug. 31, the MSCI ACWI "equal weight" index of major stocks in developed and emerging markets is up 42%. So someone randomly choosing a large sample of stocks from around the world, using a dartboard and blindfolds, and investing equal amounts in each one would probably have made about 40%.

What did hedge-fund investors earn during that time, after fees? Less than 12%, says Hedge Fund Research. No, not per year. *Total.* The blindfold and the darts beat them by a ratio of more than 3-to-1.

Some of the pension funds that lost their members' shirts in Allianz Structured Alpha said they owned the fund in order to protect against a short-term stock market collapse—like the one we had in March.

But once again, the most interesting question isn't why the Allianz funds failed to provide the protection, but why the pensions sought it. If you're running a massive pension fund, you probably don't need much protection against short-term volatility. And if you do, or you think you do, you can buy it cheaply with short-term high-quality bonds… not some overpriced fancy hedge fund of derivatives. I would bet my left leg that the trustees of those pensions can't explain how that fund works to their pension holders in 200 words or less.

The question remains: Why do these supposedly smart pension fund trustees, who hold a fiduciary duty to their pension holders, keep pursuing fancy hedge funds with counterparty risk they don't understand? Is it arrogance? Is it egotism? We are not sure… but we know it smacks of hubris and is abundantly asinine. How many more pension funds have to lose their money before we can finally stop writing articles like this one?

Is the Stock Market Divorced from Reality?

Our last piece this quarter is written by Weston Wellington, Vice President of Dimensional Fund Advisors. It is a short and easy read, and timely to boot. We hope you enjoy.

I have been sheltering in place on a former dairy farm in rural New Hampshire—surrounded by more Scottish Highland cattle than people—and relying on my iPhone and Microsoft Surface Pro to keep in touch with the office via email and Zoom video. I haven't sat in a restaurant in six months, so my dining out costs are close to zero while my grocery bill is sharply higher. I venture out every 10 days or so to stock up on supplies (Hannaford supermarket, Walmart, Tractor Supply, Home Depot) and order frequently online. Judging by the traffic on my dead-end dirt road, I'm not the only one whose habits have changed. It's only a small exaggeration to say every third vehicle going up or down the hill is a FedEx or UPS truck making another delivery, most likely from Amazon.

For many of us, the daily routine has changed dramatically from a year ago. This writer is no exception. I customarily travel extensively for business, with well over 100 airline flights and dozens of hotel stays over the course of a year. Since March 18, the number is zero on both counts, and the near future offers little reason to expect any change.

With this shifting landscape in mind, it shouldn't be surprising that some companies have prospered during this upheaval while others—especially travel-related firms—have struggled. From its record high on Feb. 19, 2020, the S&P

500 Index fell 33.79% in less than five weeks, as the news headlines grew more and more disturbing. But the recovery was swift as well: From its low on March 23, the S&P 500 Index jumped 17.57% in just three trading sessions, one of the fastest snapbacks ever among 18 severe bear markets since 1896. As of Aug. 18, 2020, the S&P 500 Index had recovered all of its losses and notched a new record high.

Many individuals are puzzled by this turn of events. For those under the age of 75, the news headlines are likely the grimmest in memory: Millions have found themselves suddenly unemployed, and storied firms such as Brooks Brothers, Neiman Marcus and J.C. Penney have entered bankruptcy proceedings.

How can stock prices flirt with new highs while the news is so discouraging? One financial columnist recently observed that the stock market "looks increasingly divorced from economic reality." (Matt Phillips, "Repeat After Me: The Markets Are Not the Economy," New York Times, May 10, 2020.)

Is it? Let's dig a little deeper.

The stock market is a mechanism for aggregating opinions from millions of global investors and reflecting them in prices they are willing to accept when buying or selling fractional ownership of a company. Share prices represent a claim on earnings and dividends off into perpetuity—current prices incorporate not only an assessment of recent events but also those in the distant future. In some sense, the stock market has always been "divorced from reality" since its job is not to report today's temperature but what investors think it will be next year and the year after that and the year after that and so on.

Moreover, the universe of stocks does not march in lockstep. At any point in time, some firms are prospering while others are floundering. This year's wrenching economic turmoil has inflicted great hardship on some firms while opening up new opportunities for others. Based on this admittedly abbreviated list below, it appears the stock market is doing just what we would expect—reflecting new information in stock prices

Company	Total Return YTD August 17, 2020
Boston Beer (Angry Orchard cider)	120.99%
Amazon.com	72.22%
Tractor Supply (new wheels for log splitter)	65.45%
Apple	57.19%
Clorox	50.26%
Netflix	49.07%
United Parcel Service (first name basis with driver)	39.79%
Microsoft (Surface Pro 4)	34.07%
Home Depot (barn light fixtures)	33.71%
Ahold Delhaize NV (Hannaford Supermarkets)	29.01%
Walmart	15.60%
Alphabet (Class A) (Google)	13.20%
S&P 500 Index	**5.95%**
Starbucks	−8.80%
Walt Disney	−10.55%
General Motors	−16.97%
American Express	−20.57%
JPMorgan Chase	−26.54%
ExxonMobil	−35.54%
Marriott Intl.	−36.54%
United Airlines	−60.95%
Carnival Corp. (cruise lines)	−70.78%

No one could have predicted the tumult we have seen this year in financial markets. But investors would do well to focus on what hasn't changed.

1. Markets are forward-looking, so focusing on today's economic data is akin to looking in the rearview mirror rather than at the road ahead.

2. Broad diversification makes it more likely that investors capture market returns that are there for the taking—including companies that do far better than expected.

3. Since news is unpredictable, a strategy designed to weather both expected and unexpected events will likely prove less stressful and easier to stick with.

Bottom line: Read the newspaper to be an informed citizen, not for advice on how to navigate the financial markets.

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(267) 983-6400

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