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# THE TEMPO VANTAGE

April 2020

## COVID-19 and Coin Tosses

As I watch TV at night and see people behaving normally, I long for the days when I could roam freely outside, shake peoples' hands, and not worry about touching metal surfaces.

How quickly our lives have changed!

I've written in the past how unforeseen, exogenous events can throw the markets into short-term turmoil. The COVID-19 virus is certainly such an event. I didn't see this coming. No one did. Yet, here we are. In only one month we have gone from market highs to a bear market.

In some ways this bear market is no different than any other bear market. From peak to trough the S&P declined by about 35%, which is the average of other bear markets since 1930.

But this decline seems scarier. Why? Because there is no end in sight.

Let me introduce two behavioral economics concepts: The Availability Heuristic and The Anchor Heuristic [1].

In the Availability Heuristic it has been shown that people make judgements about the likelihood of an event based on how easily an example, instance or case comes to mind.

Do you think that people have COVID-19 in mind today as they make investment decisions? Of course! How could they not? It's human nature.

The Anchor Heuristic showed that our minds are primed by initial exposure to a number that serves as a reference point and influences future judgements, even if that number has no bearing on the future.

After the market fell 35% what do you think people would predict for market performance moving forward? Whether they realize it or not that 35% figure will influence their answer even though "past performance is no guarantee of future results."

Combining the Availability Heuristic and the Anchoring Heuristic it is all too easy to extrapolate the declines we see today well into the future. It doesn't seem like we will ever get beyond this. But we will.

Certainly the shut-down of our economy warrants a revaluation of equities. The question is how much? No one knows for sure, but I'll give it a try.

According to Tempo's crack research staff, if the markets were to have zero earning this year, zero earning next year, and zero earnings the year after that stocks would be worth about 25% less than they were before this all started. To expect more than this requires a much worse scenario than most expert predictions.

Of course, this assessment assumes rational investors.

But we know that investors can and do behave irrationally, especially in the short run. That can take markets to extremes not supported by fundamentals (both up and down). It could also explain why we went quickly past -25% to -35%.

At the end of the quarter stocks rallied by 15% in the wake of both monetary and fiscal policy actions. That brought the decline for the quarter to 20%, as measured by the S&P 500. As is always the case, some sectors did better than others. Healthcare and technology lead the way with losses of 14%. At the other end of the spectrum were energy (-53%), financial (-34%), small caps (-32%) and international stocks (-23%).

Have we seen the worst of the decline? My rational answer is yes.

My human, emotional answer is I don't know.

My best estimate is that the market will remain volatile (to review why volatility is bullish, click here) for the next month or so with little net movement. Then, when there is a glimmer of hope (i.e. the number of new cases and deaths start to decline) it will be easier for people to see beyond the present and we will begin to see a return to normalcy.

What is more difficult to predict is how quickly the market will come back. Some say it will be a V-shaped recovery. Some say it will be a U-shaped recovery. I am in the U camp. Either way, the result is the same. The market will rebound.

To those of you who may be kicking yourselves for not reducing risk or getting out of the market altogether while you had the chance, I have some advice. Don't!

Hindsight is 20/20 and the truth is this was not easy to predict even in the early stages. No one was calling me in mid-February (when the market was at a high) asking to get out. Nor were they calling when the market was down in the single digits.

By the time I did hear from a few people the market was already down significantly, not far from where it is today. It happened that quickly!

Investing is not like a 50/50 coin toss, which is a zero-sum game. You win half the time, you lose half the time, and your expected outcome is $0. Most people wouldn't play a zero-sum game once, let alone 100 times.

In reality the market goes up roughly two thirds of the time (hard to imagine that now, I know). That is like a coin toss with the results stacked in our favor. For example, if you wager $100 in this game, you would lose $100 with a loss but win $200 with a win. Your expected outcome is +$50.

When offered to play this game one time most people decline because their odds of losing $100 are 33%, and research shows that losses hurt twice as much as gains feel good.

What if I offer you the chance to play this game five times? Would you play? With five flips your chances of losing anything are 18.75% and your expected outcome is +$250.

What if you could play 100 times? Your expected outcome is +$5,000, the odds of losing anything are 0.04%, and the odds of losing more than $1,000 are 0.0016%.

Investing is not a single coin toss, zero-sum game. It is more like a game stacked in our favor that we get to play over and over and over. This is what both traders and long-term investors know. We should always accept this "game" and over time we will win.

We recovered from the bear market in 2000-2002, we recovered from the bear market in 2008-2009, and we will recover from this.

**Tempo Financial Advisors' 1st Quarter Investment Performance**

For the first leg of the downturn (the first 15% of the decline) Tempo's Investment Programs held up quite well. Lifestyle accounts were down half as much as the overall market and Dynamic Income and Dynamic Growth were both close to break even. It seemed that my cautious stance and overall diversification were paying off.

Then the bottom fell out.

From March 4th to March 23rd the market fell precipitously and no sector was spared. Even the sectors we had been counting on for stability fell as precipitously as the overall market. High quality corporate bonds were down 28%, utilities were down 30%, and real estate was down 39% in just these few weeks! This was particularly harmful to Dynamic Income and Dynamic Growth accounts, which were overweight these sectors.

By far the worst outcome for the quarter was **Tempo Dynamic Income**, which lost 16%. Not only is this far worse than benchmarks (i.e. short-term bonds -2.2%) but the loss was three times greater than our previous worse quarterly loss. It would be one thing if Dynamic Income were billed as an aggressive strategy, but it is not. It is supposed to be our more conservative strategy. It failed.

I am not throwing out the baby with the bathwater because one quarter out of 92 is an outlier.

Accounts have been rebalanced for the second quarter and portfolios are much more conservatively positioned than before. Should the market turn lower and re-test the lows we WILL hold up much better than before.

**Tempo Dynamic Growth** was down 15% for the quarter. I had hoped for better given how well accounts held up for the first part of the decline. Still, our drop was only about 2% worse than the benchmark, which is not all that surprising given the rough time even conservative asset classes had during the second leg down. Accounts have been rebalanced for the third quarter. While we remain at our lowest allowed equity allocation, we are not nearly as exposed as before because the 60% that is not equities is more conservative (intermediate term bonds, inflation bonds, and managed futures).

**Tempo Lifestyle** accounts lost between 16% and 20% with conservative accounts losing less and aggressive accounts losing more. These results are very much in line with benchmarks. I had hoped for better (I always hope for better!), but as with our Dynamic Strategies, even some of the areas that usually hold up well during markets declines were of little help.

You may have noticed a few changes to your Lifestyle portfolio in March. These were mostly in the fixed income area where I eliminated some funds that were not holding up as well as they should have. More changes are likely over the next few months as I consider which segments of the market will outperform should the market test the lows and which will do well should the market continue up.

**Reminder**

Please contact us if there has been a change in your financial circumstances that would warrant a fresh perspective on your portfolio.

Daniel J. Traub

1. Tversky & Kahneman, 1974