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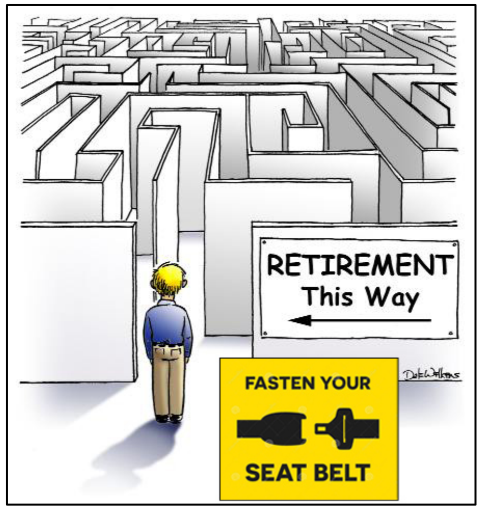
Warning: Severe Market Turbulence Ahead

"Even if you are on the right track, you'll get run over if you just sit there."
- *Will Rogers, American humorist, columnist, actor (1879 – 1935)*

Navigating the Retirement Maze



A year into the COVID pandemic, we're finally starting to see signs of a light at the end of the tunnel. Vaccination distribution is increasing, though not at the predicted nor desired pace. Hospitality businesses are starting to make plans about opening more fully, consumers are beginning to look at travel brochures again, and parents are anticipating (praying for?) a return to classrooms for their children by September.

The only thing unaffected has been the stock market. Save for a severe drop last March, followed by a rapid recovery, the 12-year-old bull market continues to chug along, seemingly oblivious to the pandemic or economic slowdown. However, warning signs are beginning to appear that this market is overheated and due for a correction. Timing is always difficult to predict, but the present situation merits prudence by investors, especially those approaching or in retirement.

History does repeat

Sir John Templeton, one of the most successful long-term investors in modern history, once said: "The four most dangerous words in investing are, it's different this time." I can still recall people saying this back in the late 1990s, when Internet stocks with no profits were moonshots, and Warren Buffett was viewed as an anachronism. Four years later, the markets had taken a severe drubbing, Buffett had regained "investment genius" status, and investors were reassessing their now diminished portfolios.

Fast forward nineteen years, and many of the same warning signs that were there in 1999 are reappearing. A comparison of sixteen commonly used measures for the US markets over time shows each one rated at "Extremely Overvalued," according to Ned Davis Research. Speculation in the market is evidenced by the recent extreme volatility of stocks like GameStop and AMC. Last year 424 special purpose acquisition companies (SPACs), also known as "blank check vehicles" because they own nothing until after the IPO, raised over $82 billion in initial public offerings (IPOs). Six weeks into 2021, SPACs have already pulled in $38 billion with 128 IPOs. How do you value a SPAC? You can't because there is nothing to value. A SPAC is a "trust me" investment.

Reaction speed is overestimated

Most active investors think that they can exit the market in advance of severe drops, though history has shown that this is rarely the case. There may be even less time to react to the next one. The 2000-2002 market collapse took two years, with the S&P 500 losing 45 percent from its peak value and the NASDAQ dropping over 70 percent. From the market top in August 2008 until the bottom in March 2009, all three major US market indices lost over 40 percent.

What should we expect this time around? Given that nowadays every market trader has their trading device in their pocket, and high frequency and program trading have become even more pervasive, I suspect that this next market correction will take a lot less time to play out than the previous two. We saw last March how much markets could move in a day, with swings of up to 10 percent. I don't expect the start of the next bear market to be any less sudden. Every stock has to have a willing buyer before it can be sold, and if most orders are "Sell," guess what will happen to prices? It's not all that different from moviegoers at a theater when the owner suddenly shouts "Fire!" Too many bodies trying to squeeze through too few doors at the same time. In other words, a recipe for disaster.

Evaluate your market exposure

At times like this, investment defense is more important than offense. The market may have some additional upside remaining, but there is probably a lot more downside. Add to that the simple math that shows it takes increasingly greater gains to recover from growing losses. Lose 25 percent, and you'll need a 33 percent gain to just break even. Down 50 percent? You will need a 100 percent gain to recover.

Markets can sometimes bounce back quickly, as they did last March, or take years to recover. From the bottom of the market in 1933 during the Great Depression, it took 21 years before the Dow Jones returned to its pre-crash level. While it's unlikely that we'll see a repeat of that magnitude or duration, it could take another five to eight years for the markets to recover from a major correction. If you're heavily invested in US equities and close to or in retirement and depending upon your portfolio to support you, this might be a good time to assess how much you are at risk.

An ounce of prevention

Take a look at your overall portfolio holdings and ask yourself: What effect would a 40 percent loss have, and how would that affect the sustainability of your assets through your retirement? A rule of thumb that I use for my clients is that they should be holding three to five years of needed financial assets in very low volatility assets like short-term government bonds. They won't earn much, but neither are they likely to fall much in a market correction. If you need those assets for living expenses, having to sell stocks that experienced significant losses means that you've locked in those losses for good.

Also, are your holdings diversified among different asset classes and geographies? Diversification is considered investing's only "free lunch," and with non-US markets at much more reasonable valuations than they are here, it might be a good time to spread out your bets.

There's a saying on Wall Street: "Bulls make money. Bears make money. Pigs get slaughtered." Don't be a pig. Consider yourself fortunate to have had your investments grow in one of the longest bull markets on record, and start getting realistic about what the next ten years of investing might look like.

George Gagliardi is a financial advisor with Coromandel Wealth Management in Lexington, where he helps clients develop and implement investment and retirement strategies. He can be reached at (781) 728-9001 or george@CoromandelWM.com. George is affiliated with Trust Advisory Group, Ltd., a Registered Investment Advisor. *This article is intended for general information purposes only, and may not be appropriate for your specific circumstances. Investment advice is particular to each individual, and should only be given after an individual situation has been reviewed.*

Coromandel Wealth Management
15 Muzzey Street
Lexington, MA 02421

Phone: 781.728.9001
info@CoromandelWM.com
www.CoromandelWM.com