Investing During COVID-19: Stick to Your Principles

It's easy to panic in the midst of a pandemic, but investors must avoid portfolio mistakes that'll plague them when the economy recovers.

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The COVID-19 pandemic has affected so much of our daily lives including, of course, our professional lives. For me as a CPA and financial advisor, this means more than working from home. It means watching interest rates drop and stock values gyrate as the U.S. and global economies continue to struggle. In times like these, it's good to ask, "When the world changes, should our investing principles change as well?"

THE OLD STANDARD

I think CPAs—regardless of whether we offer financial planning services to clients—have a pretty good understanding of the basics of investing:

- Develop an emergency fund and save or invest it in a safe, liquid vehicle.
- Invest according to the timing of goals: cash and bonds for short-term goals, equities for long-term goals.
- Remember that the expected return of an investment increases with the expected risk of that investment: equities are expected to return more than bonds, and both are expected to return more than cash.
- Reduce equities and increase bonds and cash as you age.
- Hold an appropriate amount of equities, bonds, and cash consistent with your risk tolerance.
- Diversify to reduce investment risk.
- Don't rely too heavily on Social Security to provide retirement income.

These basic principles have kept investors grounded and focused on their financial and lifestyle goals for decades, preventing them from getting caught up in the euphoria of bull markets or the despair of bear markets. And, even in this financially challenging time, I think you and your clients will find the old standard still works.

THE NEW NORMAL

Investing now is like investing during any economic recession, during a national crisis, or in a time of serious political turmoil. In other words, the lion's share of a portfolio should remain the same, and you should make small changes in response to the current environment.

Along those lines, remember that your time frame for using your assets should strongly influence the changes you make. If you are retiring, paying for college, or making a down payment on a house soon, then your time frame is relatively short and the pandemic's negative impact might have a major effect on your portfolio. On the other hand, if you don't expect to make withdrawals for years, the immediate effect of the pandemic on your portfolio—while certainly not pretty—is not as meaningful (and could be an opportunity). So,

what kinds of small changes will help your portfolio weather the current market?

EQUITY INVESTING

Historically low interest rates are pushing more investors into equities, resulting in higher price-to-earnings multiples when valuing stocks. While higher share prices are justified (to a degree), it's important to remember the earnings component of any stock must also be rising in order to support higher share valuations. The best stocks to hold for the foreseeable future might be those of companies that provide products and services most needed during the pandemic—think PPE manufacturers, pharmaceutical companies developing a COVID-19 vaccine, home delivery services, streaming services, and videoconferencing providers. Conversely, many companies that provide in-person experiences—like travel services, cruise lines, theater operators, and restaurants—are posting little to no earnings, and even losses, as the pandemic stretches on.

The pandemic is taking its toll on sector investing as well. Generally speaking, technology and consumer staples are faring better than the stock market as a whole. Because of low interest rates, the financial sector will likely underperform the overall market. Energy and commercial real estate are also likely to underperform due to reduced demand for oil and gas and rising office and retail vacancy rates.

Rebalancing your portfolio to capitalize on these outlooks seems logical, but remember that market prices are based on future expectations to a great degree. If a stock's price has already been beaten down, it may be primed for a recovery on merely an incremental improvement in the company's earnings outlook. In fact, it could be a smart move to invest in out-of-favor stocks and wait for prices to climb as earnings forecasts begin to rise. In any event, it's prudent to diversify by investing in all sectors of the U.S. economy, and simply increasing or decreasing your holdings in affected industries.

FIXED INCOME INVESTING

Low interest rates are a challenge for bond investors. Income investors must accept lower coupon payments on new bond issues and pay more to acquire bonds with relatively high interest payouts. Total return investors, who hold bonds to reduce risk in their portfolios, will enjoy the rising prices of bonds in this environment, but they face reinvestment risk when the bonds mature and need to be replaced with new, lower-yielding issues. Though this is unfortunate, I don't recommend taking any action to counter these effects. The best ways to improve yields in the face of lower interest rates—substituting bonds for higher yielding dividend stocks or investing in longer maturing or lower credit quality bonds—all require taking on more risk. In effect, investors need to bear the consequences of lower rates in the bond portion of their portfolios.

However, there is another aspect to fixed income investing during the pandemic that investors should pay attention to. Many observers suspect the $8 trillion stimulus (as of this writing) that the federal government and Federal Reserve have added to the economy is likely to be inflationary once the economy begins to rebound and the pandemic recession recedes. If this is true, then investing in inflation-indexed Treasury bonds could be attractive as their principal value is adjusted upward consistent with the inflation rate.

The bottom line is COVID-19 has spurred spikes up and down in U.S. and global stock markets throughout 2020. If you don't want to get whiplash, I suggest sticking to the tried-and-true investment principles above while making small changes to realign your portfolio with our current reality.

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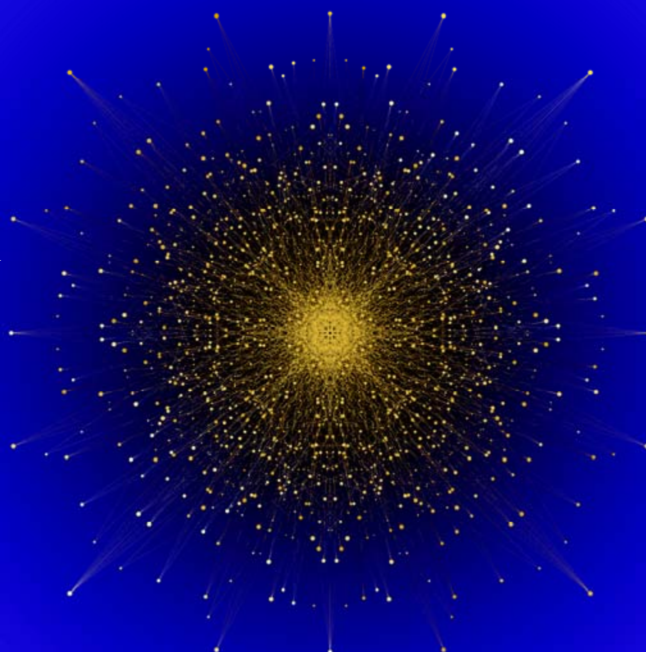

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