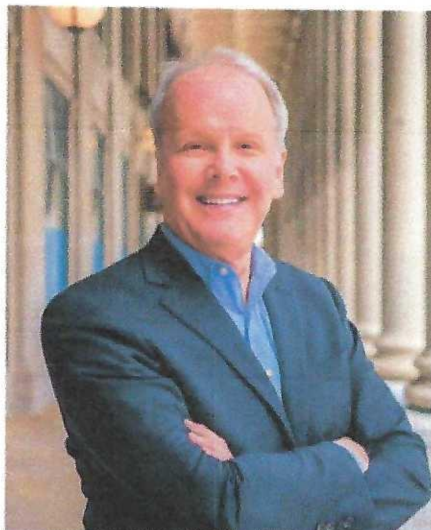

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Four Financial Planning Lessons for Turbulent Times

Wise investors and financial planners can learn from the market crashes and rallies of 2020 and heed these lessons to succeed no matter what 2021 brings.

"If you can keep your head when all about you
Are losing theirs and blaming it on you...."

Those are the opening lines of Rudyard Kipling's 1895 poem, "If," but I'm sure for many CPAs, financial advisors, and investors it sounds a lot like what we experienced in 2020! Looking back over a tumultuous year, we learned the value of cool heads and steady hands. And after dealing with the ups and downs of the pandemic, the economy, the election, and political and civil unrest, I marked some broader lessons we can glean and implement in our financial planning for 2021. Here are the four biggest lessons I'm taking to heart and imparting to my clients.

STICK TO THE PLAN

This is a point I covered in my fall 2020 Insight column, "Investing During COVID-19: Stick to Your Principles," but it bears repeating in such a turbulent environment: An effectively designed personal investment plan should meet the investor's goals, regardless of market fluctuations, over the short-, intermediate-, and long-term. Of course, 2020 brought some of the craziest market fluctuations we've ever seen. The S&P 500 lost 34 percent of its value between February 19 and March 23—then recovered completely by August 18. Investors who didn't stick to their plan may have sold tanking stocks during the decline, then bought them back after the recovery was underway, sacrificing a large portion of their personal returns.

An investment plan that can weather all storms will almost always include a mixture of stocks, bonds, and cash consistent with the investor's needs and investment risk tolerance. And in good markets—and bad—investors must stick to that plan.

PLAN FOR EMERGENCIES

One of the tools that helps investors stick to their financial plans during tough economic times is a healthy emergency savings account. The tremendous volatility of stock and bond prices throughout 2020 has caused many investors to wince, but those with emergency funds can afford to keep their investments in place and refrain from selling at inopportune times. They may have been penalized by market losses in the first quarter but should have been rewarded with sizable gains in the second and third quarters.

Unfortunately, many investors too light on cash were forced to liquidate stocks and bonds at temporarily depressed prices to meet current expenses. Those dollars were therefore unable to recover their value as the markets rose after the market bottomed in late February.

Hopefully, those investors have now learned that the solution to this quandary is to maintain an emergency fund of cash, money market funds, or CDs that remain out of the markets at all times, so they aren't forced to liquidate an investment portfolio when values are down. Alternatively, a home equity or a personal line of credit, already in place and easily accessible, can serve as an emergency fund. Whatever tool you use, having a liquid emergency fund will protect your long-term investment plan even when times get tough.

KEEP THE MARKETS IN PERSPECTIVE

Remember that the markets are leading, not coincident or lagging, indicators of the economy. When the stock market indexes began their precipitous decline in February, the economy was still humming. Unemployment was at a historically low rate of 3.5 percent, and U.S. inflation for the 12 months ending January 2020 was 2.5 percent. Logically, data like that should support a rising, not falling, stock market. But investors looked at the rising coronavirus positivity and death rates around the world, recognized the probability that this pandemic would spread to the U.S., and began selling in massive amounts, taking stock prices down.

Likewise, by the time the markets commenced their recovery in March, investors had taken note of the tremendous amounts of fiscal stimulus and monetary accommodation provided by national governments and central banks around the world, and began to bid stock prices higher. This all took place against a backdrop of large-scale economic shutdowns, a U.S. GDP decline of 5 percent in the first quarter, and a March 2020 U.S. unemployment rate of 4.5 percent. In the following months, unemployment rose (going as high as 14.7 percent), GDP declines accelerated (to negative 31.5 percent in the second quarter), and the inflation rate fell into negative territory. These are all historic signs of a weak economy—yet many market indexes have reached all-time highs.

Those highs were driven by investors' belief that coronavirus vaccines will be developed and safely administered globally, and that further fiscal stimulus and accommodative monetary policy will continue to flow into the global economy—even though these developments may not further materialize until 2021. Thus, they have shrugged off the present high unemployment and low inflation figures and are bidding stock prices higher according to perceptions of future scientific and government responses to the current situation.

DON'T FIGHT THE FED

One of the best lessons for investors in turbulent times is to understand the measures the Federal Reserve took to combat the economic challenges brought on by the coronavirus. The Fed initiated an accommodative monetary policy by providing multiple lending facilities to its member banks to make funds available to borrowers at attractive interest rates. Then the Fed embarked on programs of purchasing financial assets, known broadly as quantitative easing, therefore increasing demand—and prices—for those assets. Finally, the Fed affirmatively modified its approach to controlling inflation and signaled a willingness to let inflation rise meaningfully higher than its 2 percent target, therefore implying that rates will continue to remain low—perhaps for years.

All these actions have the cumulative effect of raising the value of financial assets—despite the current economic environment, and sometimes even if the near-term outlook shows no signs of improvement. To investors, this is a signal to increase investment in otherwise risky financial assets and is ultimately why many wise investors manage their portfolios around the Fed's policies.

It is the nature of financial markets to rise and fall, sometimes dramatically and quickly, because their behavior reflects that of humans. When events occur like the dot-com bubble bursting in the early 2000s, the financial collapse that began in 2008, and most recently the coronavirus, they interrupt our collective complacency and cause us to reexamine the tenets of personal finance and investing. I believe the key to surviving financial shocks like these is to take the lessons above to heart, follow them, and manage your expectations—that is, to keep your head when all about you are losing theirs.

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