



Retirement | Investments | Estate & Tax Planning

Five Questions Answered

SYNOPSIS

- Investors are anxious to understand the reaction in global financial markets to the outcome of the presidential election.
- More specifically, they want to know why conservative and income-focused portfolios have failed to keep up with the broader equity market.
- Much of the volatility has been fueled on emotional moves by traders who are trying to guess what a Trump presidency means for the future.

WHAT'S GOING ON?

Financial markets are still digesting the ramifications of a new administration heading to DC in January. These gyrations have understandably made investors curious, often frustrated, as to why some investments have done so well while others have gone the opposite direction.

To provide some clarity, here are answers to the five most common questions asked by investors since Election Day.

1. Why did my portfolio fall or stay flat when the S&P 500 was up so much last week?

There are two reasons why conservative portfolios did not participate in the post-election stock market rally last week.

First, conservative portfolios have a larger allocation to bonds than to stocks, and the fixed income market has come under pressure since the election results were announced because traders believe that Trump's fiscal spending plan will cause inflation to rise.

Inflation is bad for bonds, particularly longer-term bonds, and traders responded quickly by selling 10-year Treasury bonds, which caused their yields to increase.

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The 10-year Treasury is a critical benchmark to our economy because its yield is often the foundation for mortgage rates and many other loans. Since it is so important, the selloff fueled volatility across the bond market impacting any portfolio with a sizeable bond allocation.

Second, the stocks held in a conservative portfolio typically pay dividends and have lower valuations when compared to the S&P 500 (over 80 stocks in the index pay no dividend). Hence, the equity allocations in conservative portfolios do not always track the broader indices because their compositions can be quite different.

2. Why did I have so much exposure to what fell since the election?

Diversification is the "Golden Rule" of investing, and let's see why it is so important for conservative investors to always remain diversified by going back to the night of the election.

Since a Clinton victory had been priced into the stock market, a lot of market participants were caught off guard when Trump won. Markets hate uncertainty above all else, and the unexpected win caused Dow Futures to fall 750 points



before midnight. Had this trend continued into Wednesday's open, any investor sitting in an all-equity portfolio could have been down around 4-5% to start the day.

Diversification is used to protect conservative investors from too much volatility from a single asset class. Hence, conservative portfolios are designed to do better when stocks fall precipitously, but the cost of this protection is that they typically do not participate as much on the upside when stocks surge.

3. Why have income-producing portfolios been under so much pressure?

The combination of expectations for an interest rate hike in December with the surprise move in the 10-year Treasury bond has wreaked havoc on income-producing portfolios because they are more sensitive to interest rates when compared to the broader stock market.

Additionally, since so many investors over the past few years have become desperate for yield, the demand for dividend-paying stocks has caused the valuations in many stocks to surge to record highs. Stocks that trade at high valuations also tend to be more volatile.

4. Should conservative and income-seeking investors be worried?

There are three reasons why these investors should not be worried. First, the knee-jerk reaction to Trump's win has been purely emotional. There is little clarity on his administration's true plans for change, and investors should never bet on the direction of a government decision. Even if Trump does get his

policy decisions implemented, it will be months or possibly years before any impact will be felt.

Second, it's not like a selloff in bonds and dividend-paying equities will somehow cause money market and bank CD rates to go back to a suitable level. Those days are long gone, so eventually, those who sold will be forced to return to the very same assets if they want to continue to receive income.

Third, volatility is to be expected in today's income strategies due to the mechanics of dividend-paying stocks and other cash-producing assets. They require patience over a multi-year holding period to work properly, but let's walk through some math to see why this volatility should not scare a conservative investor.

When a company pays a dividend, the value of that firm falls by the amount of the dividend paid. For example, if a firm is worth \$500 million and they use cash to pay a dividend totaling \$50 million, then the resulting value of the firm is \$450 million ($\$500 - \$50 = \450). Since the firm now has \$50 million less in the bank, the stock price must be reduced by that amount.

The key point to remember here is that shareholders do not gain or lose at the time of payment. The value lost from the decline in the stock price is equal to the amount of cash received from the dividend.

Investors must then wait patiently for the company to rebuild that \$50 million in value by selling more goods and/or services. Over time, this cycle causes



the stock price to go up and down. Add to this the ebb and flow of the market from emotional moves by traders and we are left with investments that will likely remain volatile for the foreseeable future.

Another way to think about income strategies is to compare them to a rental property. On any given day, week, month, or even year, the value of that property changes dramatically due to the volatility in the real estate market.

Would you kick out a good tenant who consistently pays the rent on time and sell the property simply because the real estate market was in a downturn?

5. Why have some investments done so well while others have done so poorly?

Here are a few asset classes and investments that have surged since the election:

- **Financial Stocks:** Traders believe that Trump will roll back much of the regulation that has held banks back during the Obama administration. Add this to a rising interest rate environment, and the profitability of the sector could dramatically change for the better.
- **Commodities:** Trump's plan to spend half a trillion dollars on infrastructure will require a lot of raw materials like steel and copper. Companies that sell these materials have risen in lockstep with the price of the underlying commodity.
- **U.S. Dollar:** Trump's economic plan is expected to lead to faster economic growth, which could lead to higher inflation and cause the Fed to raise rates faster. These outcomes act as adrenaline shots for the dollar.

- **Small Cap Stocks:** A potentially faster-growing U.S. economy combined with threats of tariffs on imports make domestic firms more attractive. Small caps fit this theme nicely.
- **Biotech Stocks:** The concerns over a Clinton victory leading to the government controlling drug prices is no longer warranted and has led to a "relief rally."

Those that have suffered over the past week:

- **Municipal Bonds:** Along with the broad-based weakness in the fixed income market as explained above, Trump's plan to cut taxes could lower revenues for municipalities.
- **Technology Stocks:** A trader who has made good money owning technology stocks over the past year that wanted to swap over to bank stocks may take profits in tech and buy bank stocks.
- **Utilities & Telecom Stocks:** These sectors are "bond proxies" because investors own them for income.
- **Mexican Peso:** The currency has become a trading vehicle for speculators betting on the outcome of the election. Concerns that Trump is going to renegotiate trade agreements with Mexico has caused the currency to weaken dramatically.
- **Global Government Bonds:** The election caused over \$1.5 trillion to be wiped out of the global bond market in less than a week after the election, showing the influence of U.S. interest rate expectations across the globe.

Some of the activity is in response to material shifts in asset prices. For example, a rising interest rate environment with the potential for higher



inflation could very well bring an end to the three-decade bull market in fixed income. This warrants action, however, most of the volatility is nothing more than day traders trying to make a quick buck.

The bottom line is that the fundamentals continue to point to slow and steady economic growth, and it is just too early to tell what the presidential election will mean for most of the investments that have surged and fallen over the past week.

Sincerely,

A handwritten signature in black ink, appearing to read "Mike Sorrentino", written in a cursive style.



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