Norman J. Politzner's
Financial Planning

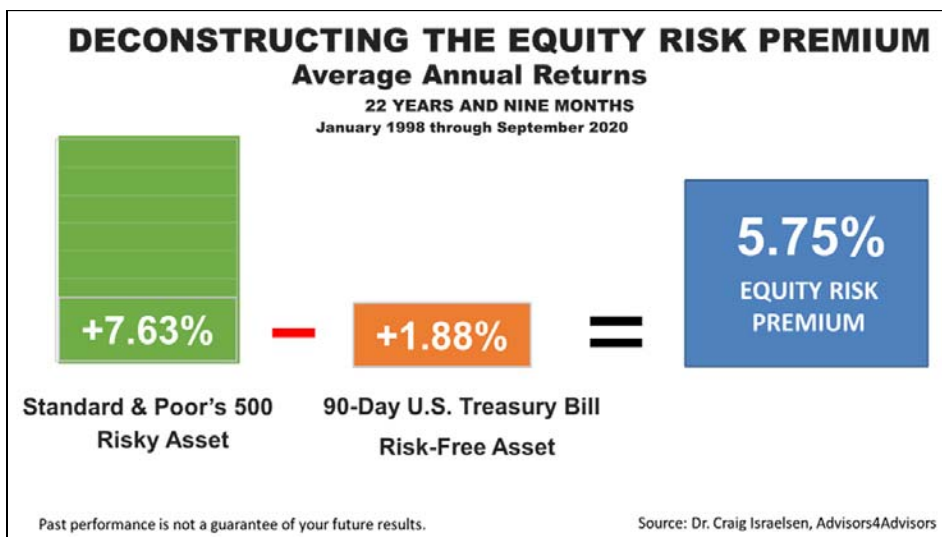
Fourth Quarter 2020 www.politziner.com (732) 296-9355

Earning The Equity Risk Premium Return Of 5.75%

During the Covid pandemic, one day drops in stocks of between -3% and -5% have not been uncommon. And then there was March 12, 2020, a one-day plunge of -12%!

Times of painful stock market losses are when investors earn the equity risk premium. The equity risk premium is financial jargon for "the vig," the extra return investors were paid for taking a risk. Successful investing requires an understanding of the risk premium on stocks. So here's a look at the vig in recent months on the Standard & Poor's 500 index, a period that includes the outbreak of the Covid pandemic in the U.S.

To quantify the post-Covid equity risk premium, look at the equation in the graphic: Over the 22 years and nine months ended on September 30, 2020, the risk-free 90-day U.S. Treasury bill averaged an annual return of +1.88%, compared to a +7.63% annualized return on the S&P 500 stock index.



Subtracting the 1.88% from the 7.63%, resulting +5.75% represents the premium stock investors have been paid annually over the boom and bust cycles since 1998. Put another way, owning stocks through the tech bubble in 2000, financial crisis in 2008-2009, and COVID outbreak bear-market rewarded investors with a premium of 575-basis points over what they would have earned by investing in risk-free 90-day Treasury bills.

The chart on the last page does a better job of illustrating the scary parts of the equity risk premium. The red data series shows the daily changes in the stock market, as represented by the price of a share of the S&P 500. Enduring a loss of one-third of your portfolio's value, for some investors, was a stomach-wrenching experience. Sometimes, earning the equity risk premium is hard.

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Goodbye And Good Riddance

Hooray, it's a new year... or is it? 2020 was a bummer, so I won't rehash it except to say that despite the pandemic, there were strong indications that the economy is poised for a significant recovery. The third and fourth quarters were strong, and the stock market responded.

Those trends continue today. Personal savings are at a near-record high, and pent-up demand foretells a great year once most people get vaccinated. The CDC estimates that about 83 million people were infected with COVID-19. Most were asymptomatic. Those, along with the newly vaccinated, will bring us close to herd immunity, and restrictions will (should) loosen up.

That is the good news. Considering that the pandemic will morph into an endemic, like measles or flu, it will create other behavioral changes and accommodations, but life will be much better, I believe, in a few months.

People will be able to travel more, visit more, and stress less. Kids will be back in school—that's the science, folks—and parents will be back at work. There is a new federal administration with different policies and priorities, and maybe less rancor in the public square (a hope, not a prediction).

As for me, being able to visit family in Colorado would be great and long overdue. We have been lucky that our grandchildren live so close to us so I can be constantly reminded that my dancing and basketball days are long gone. Being a grandparent is quite revealing.

Here's to 2021. It's not 2020.

Norm

Private Wealth's Perfect Storm

Amid the Covid pandemic, changes in tax, financial, and economic arenas have created a deluge of added complexity for advisors managing private wealth. Here's an overview of the abrupt change in conditions now battering private wealth, which, when taken together, amounts to a "perfect storm:"

Tax Policy. Budget shortfalls across the states as well as at the federal level are expected to result in steep hikes to state and federal income and transfer taxes.

Taxable Estates. For individuals with taxable estates, the current exemption of $11.58 million from estate and gift tax will be cut in half January 1, 2026. However, the exemption amount could be cut much sooner, depending on the outcome of the November 3 election. Changes in tax policy increase the downside risks of failing to plan. While 2026 may sound a long way off, preparing now to maximize annual gift-tax exclusions, charitable donations, and appropriately tailored trusts to accomplish your goals can ensure a lasting legacy.

Lowest Rates In Decades. Every month the IRS releases the minimum interest rates you are permitted to charge on loans to family members, trusts and other related entities. With this "applicable federal rate" currently at less than 1%, loaning assets may be a savvy way to transfer wealth to the next generation for buying a home, starting a business, or making charitable bequests. The loans are sometimes part of a plan to transfer a family business, or support children with special needs. With the pandemic potentially lowering the value of real estate and business assets, and causing frequent stock market volatility, optimizing low interest rates to make intrafamily loans is suddenly a more viable solution to reducing taxes and enhancing legacy planning.

Liability Explosion. With tenants more often unable to pay rent, and small businesses facing financial difficulty, landlords and business owners are suddenly facing an explosion in their liability exposure. Asset protection strategies to mitigate personal liability exposure in the event of a setback requires preparation before a problem arises or facing a legal challenge.

The Covid pandemic abruptly changed tax and financial conditions affecting estate tax and asset protection drastically, and this perfect storm requires proactive engagement of family members as well as advice from tax, legal and financial professionals. Please contact us with questions about your personal situation. ●

Three Easy Ways To Increase Your Chance Of Financial Success

Changing your financial behavior can be an important step in determining your long-term financial success. Here are three simple activities that can help.

Automate. Infrequent interventions, such as budgeting once a year, are less likely to bring success than more automatic actions that occur quarterly or monthly. Enrolling in a salary reduction plan which takes money from each paycheck and goes into your qualified retirement plan illustrates the difference between decisions that require your recurring action versus those that are automated. What else might you automate to increase your savings or make sure you pay your bills? Examples include signing up for a newsletter, webinar series, or class about tax and investment planning. The easier you make it to become educated about a topic you might not otherwise research regularly on your own, the more likely you are to seek out the knowledge you need to be more fully engaged in learning and find answers to the important questions.

Write it up. Whenever

Covid, The Fed & American Exceptionalism

The Coronavirus financial crisis is being compared to the near collapse of the global financial system in 2008 and The Great Depression from 1929 to 1939, but there is one big difference this time: The Fed. The Federal Reserve Bank is using innovative new tools to contain the financial damage of the Coronavirus epidemic.

In the financial crisis of 2008, the chairman of the Fed at the time, Ben Bernanke, an academic who had spent decades studying previous financial crises, repeatedly deployed a technique called quantitative easing (QE). QE expanded the Fed's balance sheet to buy back U.S. Government bonds on the open market, thus, lowering long-term interest rates.

Never before had the tactic been used by a central bank in a major economy. It worked, however, and QE was one of the reasons the U.S emerged successfully from The Great Recession of 2008 and 2009. The Fed's present response to the Coronavirus crisis is literally 10 times more powerful.

Under the $2.2 trillion Coronavirus Aid, Relief, and. Economic Security (CARES) Act enacted March 27, 2020, the U.S. Government allocated $454 billion to Federal Reserve Bank Special Purpose Vehicles that the central bank can leverage 10 to 1, thus enabling it to lend up to $4.54 trillion to companies in financial distress.

That sum is reportedly more than all U.S. commercial and industrial loans outstanding at the end of 2019, plus all the new corporate bonds issued during 2019 combined! Although the expansion of the Fed's power has been criticized as a step toward a centrally planned economy, this government action limits the risk of potentially massive corporate bond defaults and corporate bankruptcies.

The U.S. led the worldwide economic recovery following the global financial crisis of 2008, in part because of the Fed's innovative approach. And now, this most recent display of Yankee ingenuity -- in the form of the Fed's new tools -- is at play once again in fighting the Coronavirus-induced financial crisis.

In these frightening times, the Fed's new toolset is likely to become a mere footnote in history books that will be written about the pandemic in the decades ahead. Ever since Alexander Hamilton established the first U.S. central bank in 1791 to respond to the financial crisis that followed the Revolutionary War, the uniquely American central bank has enabled the progress of civilization through financial crises. The U.S. Government response to the Coronavirus financial crisis is a shining example of what makes America exceptional among the nations of the world. ●

you make a major financial decision, write yourself a note about your decision. By jotting down your analysis at the time you make a decision, you'll create an introspective record that, over the years, will help reveal successes and failures.

Increase self-awareness. Your financial personality can help or hinder your financial success and you may be entirely unaware of it. Increasing self-awareness can help you avoid sabotaging yourself. The burgeoning social science of behavioral finance can help you learn about your financial personality traits. For example, would you rather receive $160 today or $246 in 12 months? How about $160 today or $180 in 12 months? Your answer to a series of questions like this can reveal your predisposition toward deferring rewards now in favor of reaping financial benefits from a long-term plan. Similar questions can guide you in determining how likely you are to tolerate losses in bear markets, whether you are overconfident about your financial decision-making abilities, and offer hints of the types of investments that might work best in a long-term portfolio designed to help you accomplish your financial goals.

If you would like to talk about other steps you can take to ensure healthy financial behavior, please do not hesitate to contact us. ●

Asset allocation cannot eliminate the risk of fluctuating prices or uncertain returns. Diversification does not assure a profit or guarantee against loss.

SEC Is Struggling Amid Covid Pandemic

Since it's probably not on your reading list, here are highlights investors need to know from the 2020 annual report of the Enforcement Division of the U.S. Securities and Exchange Commission.

Policing Securities During Covid. "By mid-March, the entire Division had transitioned to mandatory telework and essentially all of our operations were conducted remotely," says Stephanie Avakian, director of the division.

An Epidemic Of Fraud. Covid inspired a wave of investment fraud. In March and April alone, the Commission suspended trading in the securities of two dozen issuers where there were questions regarding the accuracy and adequacy of information related to COVID-19 that those issuers injected into the marketplace, including claims about potential COVID-19 treatments, the manufacture and sale of personal protection equipment, and disaster-response capabilities. All told, from mid-March through the end of the fiscal year on Sept. 30, 2020, the Division's Office of Market Intelligence triaged approximately 16,000 tips, complaints, and referrals -- a roughly 71% increase over the same time period last year -- and the Division opened more than 150 COVID-related inquiries and investigations and recommended several COVID-related fraud actions to the Commission.

A Decline In Total Actions. Understandably, total enforcement actions declined, during this initial period of the Covid pandemic. A total of 715 enforcement actions were filed in the 12 months ended September 2020. Taking depositions, getting sworn statements, and related legal procedures were moved online, disrupting investigations and prosecutions of securities crimes. Although total enforcement actions declined, stiffer penalties were assessed.

"While the number of cases the Commission filed was down as compared to last year, the financial remedies ordered set a new high," according to Ms. Avakian's public letter, accompanying the report.

The Bad News For Financial Consumers. A breakdown of the number and percentage of the types of actions brought in Fiscal Year 2020 is bad news for investors. The agency took enforcement actions against half as many investment advisers and mutual funds as in FY2019. SEC data combines investment advisors serving individuals with companies managing mutual funds. These are two key sources of financial advice and the plunge in enforcement actions when complaints, tips and referrals from other agencies soared by 71%, is cause for concern. If you're saving for a child's college education, your retirement, or for the benefit of your heirs, the sudden plunge in policing by regulators puts a bigger burden on you to be wary of financial sales pitches. It's more important than ever to work with a professional you know you can trust. ●

Source: U.S. Securities and Exchange Commission, 2020 Division of Enforcement Annual Report; released Nov. 2, 2020.

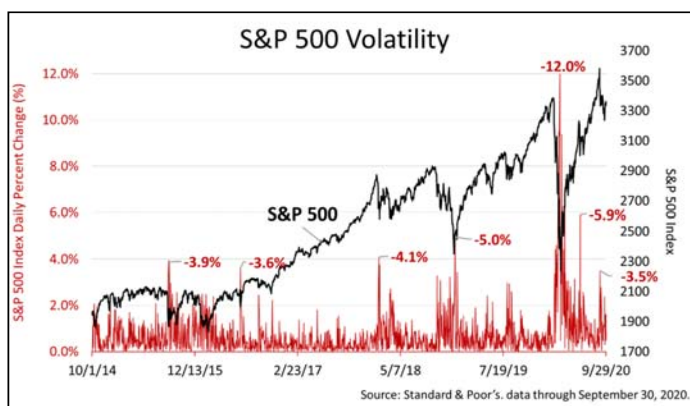
The Equity Risk Premium

(Continued from page 1)

Armed with these kinds of statistics, however, knowing that big daily down days reliably do come, it is easier to withstand the uncertainty.

With the COVID outbreak tragically surpassing 1,000-deaths in a day and the changes in all three branches of the U.S. Government, the risk of a stock market plunge looms larger. However, permanent investors who plan to own stocks for the rest of their lives would be wise to view volatility as a friend.

That may be counterintuitive, but it absolutely is valid. Choosing to expose a portion of your portfolio to price volatility, also known as risk, justifies a better return. You wouldn't earn the six percentage-point equity risk premium on stocks, if you weren't exposed to lots of volatility. It just goes with the territory. It's part of owning a risk asset. ●



Source: Standard & Poor's. data through September 30, 2020.

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