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Putting Recent Events in Perspective

Overview: The following provides some perspective on many of the issues that have worried investors throughout 2012.

Patient, disciplined investors with well-developed plans are subject to the same noise and concerns that plague other investors. Over the past year, most investors have noticed or been concerned about:

- Our continuing federal budgetary deficits and our ability to continue to fund them
- The upcoming "fiscal cliff" spending cuts and tax increases slated to go into effect in 2013
- The increased possibility of inflation caused by monetary stimulus
- The European fiscal crisis and the potential for sovereign defaults and the breakup of the Eurozone
- Rapidly slowing growth in China and other developing nations

These are all legitimate concerns. But ask this question: Are these risks generally known? Because these events have been an almost daily part of the public conversation for most of 2012, we would expect that the likelihood of these events occurring has already been built into current prices.

To frame the conversation about these economic issues, let's analyze the question of the concern over the fiscal cliff — the combination of tax increases and mandatory spending cuts that are scheduled to hit as of January 1, 2013 (such as the expiration of Bush income tax cuts). One outcome would be some kind of temporary extension that just kicks the can down the road, so that very little of what is scheduled to happen will actually occur. One reason this could occur is we are able to borrow more cheaply than ever. Thus, there is little pressure from the bond markets for us to rein in the U.S. deficit.

If the fiscal cliff does actually happen, however, the tax increases in particular could negatively affect the economy. The Congressional Budget Office (CBO) projects the impact would be about a 0.5 percent contraction in the economy in 2013. However, some are skeptical that the spending cuts would be nearly as harmful as the CBO projects, expecting that the negative of any spending cuts could be offset by the benefits provided by the knowledge that future deficits will now be lower.

From an investment perspective, it is assumed that markets have factored in the possibility of the fiscal cliff happening and assigned some probability to it not happening. So, if the fiscal cliff does not happen, stock markets could respond positively, and the opposite if it does happen. This is no different than saying the market has assigned some likelihood the Eurozone could unravel and some likelihood it does not, and the market will act accordingly depending upon which scenario occurs.

It is not surprising some investors are worn out and discouraged by current events and what they see in the headlines. Consider how some investors have reacted to the European crisis. Over the past year, Europe has been caught in the eye of a financial storm. European equities experienced sharp losses and bond yields on sovereign debts soared as credit ratings were slashed. Some investors see the crisis and the risks, but they cannot see beyond that.

This type of stage-one thinking leads to sales of assets as investors assume the bad news means prices are surely going lower. They assume the only light at the end of the tunnel is a truck coming the other way. The result: Sales occur after prices have already fallen, reflecting the bad news. Those sales occur when prices are low and expected returns are high (reflecting the high perception of risk).

On the other hand, stage-two thinking involves seeing beyond the crisis. For example, while there is no certainty, most would expect that a crisis would lead governments and central bankers to come up with solutions to address the problem. If the crisis worsens, the more likely they would be to act with urgency and scale. Stage-two thinking allows one to see that the light at the end of the tunnel might not be a truck coming the other way. Instead, it might be actions to help resolve the crisis.

In response to the crisis, European governments and the European Central Bank have taken a series of actions including slashing budgets, cutting rates and implementing bond-buying programs. When the first actions were not sufficient, they took further ones and that has continued throughout the year. (Note that these actions were a virtual replay of actions taken by the United States.) Despite the fact that there is still no clear resolution, European equities are, in general, doing quite well. For example, from January 1, 2012 through August 31, 2012, the MSCI Europe Index had a total return of 8.1 percent.

Conclusion

The emotions created by crises can cause us to lose perspective — like forgetting that fairly regular crises are actually the norm. Having a well-developed plan, one that includes the virtual certainty you will have to face many crises over your investment horizon along with the ability to avoid stage-one thinking, should give you the best chance of achieving your financial goals.

While you cannot control the market, you can control the course of your overall investment strategy. If you feel a change is necessary, a prudent first step would be to re-evaluate your asset allocation plan within your current Investment Policy Statement and reconsider your ability, willingness and need to take risk. Possible actions include adjusting your goals or deciding to work longer, so you can take less equity risk. This will not only allow you to sleep better and enjoy your life, but it will also give you a better chance of staying disciplined — the key to successful investing.

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