Weathering Financial Storms

Ways to thrive in a down market

From the Ready Retirement System

By

Mike Heckman MS, CFP®, CEPA®

10212022-PM-22186

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Mike Heckman has a down to earth “no jargon – no sugar coating” approach to helping his clients. He believes that it is vitally important to have access to sound financial advice to grow and preserve wealth and pass it on to future generations. Mike’s passion about the “no-jargon – no sugar coating” approach comes from his own personal experience. At the age of just nineteen, Mike had to settle his father’s affairs who died intestate, without will or other estate plan.

Joshua 1:9: “Have I not commanded you? Be strong and courageous. Do not be afraid; do not be discouraged, for the LORD your God will be with you wherever you go.”

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No matter what part of the country or the world for that matter, we live in an area where mother nature shows her wrath by flinging storms in our direction.

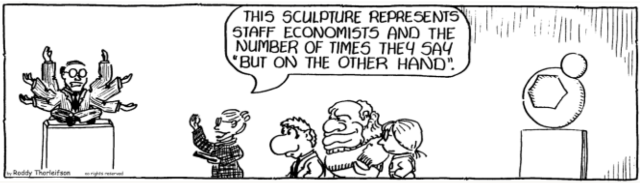
I grew up in a small home in a small town not far from Lake Michigan. Although we were much more likely to have a rough time from blizzards, my boyhood fear was 100% tornados. “It’s a T!!!!” was the code word from another family in the Midwest, that completely resonated with me. I tried to find comfort in reminding myself that tornados did not come through that part of Michigan very often and that we had stocks of food and water should the power go out.

Like planning for a bad storm, preparing for financial storms is key: If your plan is sound, then you are prepared for when the storms come. You should know where your living essentials are going to come from, and you know that your house is built from sound construction materials and design. The steps to prepare your financial storm shelter is not too dissimilar to that in which you create a storm cellar. The three components to set up your financial storm cellar are mindset, emergency fund, and first aid kit.

Just like I needed to know where my food is going to come from and that tornados didn’t happen often where I lived, investors need to know where their short-term income is coming from and that down markets go away as well.

Mindset:

Emotional Awareness, Perspective, Faith



Mindset: Emotionally Awareness:

The diagram below shows a typical cycle of investor emotions, or our probable responses to the rise and fall of our investments.

Source: Barclays.

The above graph from Barclays graphically represents common investor emotions during stock market cycles. It is beyond the scope of what time we have here to do a proper deep dive into investor emotion and behavior. For now, we need to understand that our feelings during market cycles are quite common and normal. We are wired to fly and fight when we have this discomfort. The best time to reallocate into stocks, or to invest may be when we feel the worst. Often, the best time to lock in gains is to sell that very investment that just made you more money than expected. If your plan is sound stick to it and consider rebalancing (Covered in the first-aid kit chapter).

2 Timothy 1:7: "For the Spirit God gave us does not make us timid, but gives us power, love and self-discipline."

Perspective may help you get into the right mindset to thrive in financial storms.   In high school, I enjoyed math and science. The only class I had to take twice in high school was US History. I have since become a lover of the stories that make up our past, and the history of monetary systems is a key character in these stories. I was reminded of this when my eleven-year-old Cody quoted from his social studies class, “people move because of 3 G’s: God, Gold, and Glory”.

Investment history helps keep perspective knowing that every other time in human history, markets have recovered and then expanded. From 1926 to the time of this writing, the S&P500 has returned positive 71 years at an average of 21.3%, and 25 down years at an average of -13.2%. Staying invested through this time from 1926 through 2021 would have averaged 10.5% compound**, which would double the investment balance a little faster than every seven years(1).

**Source: Ibbotson Associates. For illustrative purposes only and not indicative of any actual investment. The S&P 500 Index is an unmanaged index of 500 companies used to measure large-cap U.S. stock market performance. Investors cannot invest directly in an index. Index returns do not reflect any fees, expenses, or sales charges.

Otherwise stated: (1)

S&P 500 1926 - March 2022

Average Annual Return: 10.5% compound

Number of Positive years: 71 (Average: 21.3%)

Number of Down years: 25 (Average: -13.2%)

Faith is the second component to getting your mindset right in financial storms. I hesitate to say biblical faith, but for me, that is part of it. There are 365 passages in The Bible that comfort and assure us to dispel our fear, one for each day of the calendar year.

John 14:27: "Peace I leave with you; my peace I give you. I do not give to you as the world gives. Do not let your hearts be troubled and do not be afraid."

Other components include faith in economics and markets, our systems are designed to keep getting better. As an investor, I hope that you have faith that the US economy is driven by forces of people working in their own best interest, these complex market forces are dynamic, almost alive, and hungry. This force drives for better, more efficient and often ends with results for the betterment of the common good. More choices and better prices are good for the consumer, which we all are.

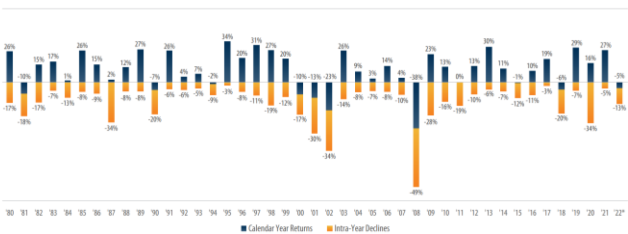
"And now as promised, the essential epiphany of true, long-term faith in the future, stated as an affirmation:

'I can't know exactly HOW things are going to turn out all right.'

'I just know THAT things are going to turn out all right'" – Nick Murray (3)

Read your history, cut the noise, keep the faith

The mindset required to weather financial storms comes from perspective and faith. Understanding the perspectives on money and market histories may help. Volatility is not a new occurrence in financial markets. The chart below contrasts the market declines each year and the resulting calendar year return. Even though the S&P 500 has averaged over 13% annually since 1980, the chart below illustrates that it has never been a smooth ride:



In the above graph, the lighter bars indicate the low point of equity markets for the given year. The darker bars track the end of year return.

Source: Bloomberg, First Trust Advisors, L.P. As of 3/31/2022

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Understanding the perspectives on money and market histories may help, but there is a lot of noise. The twenty-four-hour news cycle, social media alerts in real-time on the phone, and coffee talk conversations all add to the fear factors that can lead to mistakes including inaction. No one makes good decisions when they are drunk or when they are panicked.

"The stock market is a device for transferring money from the impatient to the patient."

– Warren Buffett

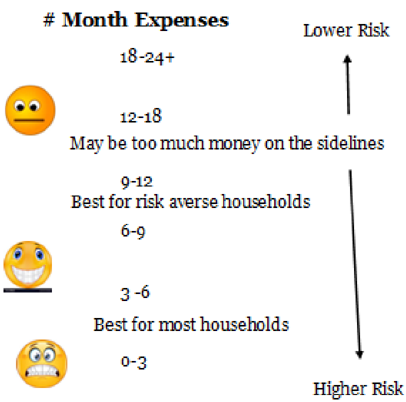
First-Aid Kit

If you are confident that your plan will get you where you want to go, then you are long on your way to weathering a financial storm. The first aid kit is a few suggestions on actions to consider that may increase your net worth during down markets.

First-Aid Kit: Emergency Fund

The best time to stock up on emergency supplies is when there is no emergency. If you want to buy flashlights in a small town with the power out, many stores are closed and many store shelves are empty. An emergency fund should be stocked before a crisis, it would be a mistake to liquidate an investment when it is undervalued, to check the emergency fund box on your checklist.

When deciding on an appropriate emergency fund, you should have some clarity on monthly expenses and how much cash you need to feel secure. The CFP® board recommends at least three months of expenses in a household with two or more income streams. At least six months of expenses is recommended for households with only one stable stream of income. The monthly expense number should be a smaller number than your monthly income. Holding more cash in an emergency fund than recommended is inefficient because you are not earning more potential return. The opportunity cost to this extra safety net is that you may be sacrificing your long-term net worth by holding too much cash in your emergency fund.



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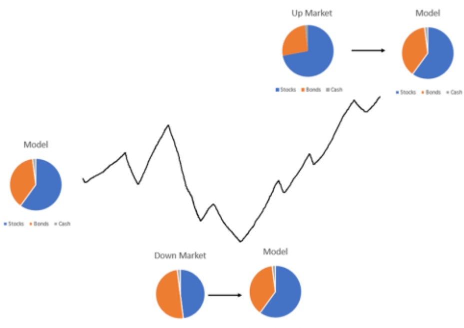
**1 Peter 5: 6 – 7: “6 Humble yourselves, therefore,
under God’s mighty hand, that he may lift you up in
due time. 7 Cast all your anxiety on him because he
cares for you.”**

First-Aid Kit: Rebalance

If we can assume that you have confidence in your plan, then the development of your plan incorporated a target allocation among asset classes. This target allocation should have considerations for your risk appetite (Risk Tolerance), the amount of return needed to meet the stated financial goal (Risk Capacity), and real diversification.

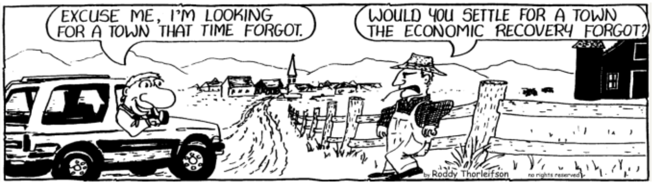


Rebalancing occurs when selling over-weighted positions to buy shares in asset classes that are the most depreciated, shifting the portfolio back to the target allocation. As markets recover, this move can add net value to a portfolio. Rebalancing works best when done on a predetermined schedule or when asset classes ‘drift’ out of identified risk tolerance. A rebalance should also consider trading costs and any tax implications on non-tax-qualified assets.

Example: 60/40 Model Portfolio:

Up Market: **Sell High.**

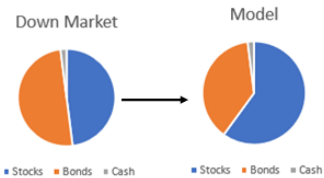
During an up market, high growth assets have grown faster and are higher in relative valuation. A rebalance would sell some of these shares and buy lower risk assets, locking in gains.



Example: 60/40 Model Portfolio:

Down Market: **Buy Low**.

During a down market, higher growth and volatility assets lose value, more stable assets are sold to buy more shares of these investments when they are relatively undervalued.



Note: Rebalancing does not protect against investment loss from fluctuations. Rebalancing takes advantage of relative market valuations. Rebalancing should not be used as a market timing instrument.

First-Aid Kit: Tax-Loss Harvesting

Tax-loss harvesting is a tool that is utilized by selling investments that are underperforming. These investments most often have lost value since their purchase. These underperforming investments are sold, then the proceeds from this liquidation can be used to buy different investments. The investor also may choose to hold the proceeds in cash. The cash position must be held for more than thirty days. The ‘wash sale’ rule negates the benefit of the tax loss harvesting if the same, or substantially same asset is re-purchases in this thirty-day period.

The potential tax benefit is that these realized tax losses can offset realized investment gains. This may reduce the capital gains tax burden on more successful trades and can possibly offset some of your ordinary income.

During down markets, you may wish to consider selling long-held positions that are no longer ideal as part of an investment portfolio. Selling these positions when reduced in value may have less tax implication in a non-tax-sheltered account.

Caution: Tax-loss harvesting has no tax benefit in tax sheltered accounts such as 401(k), 403(b), Roth, or Traditional IRA accounts.

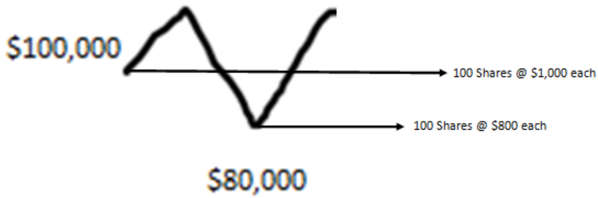
First-Aid Kit: Roth Conversion

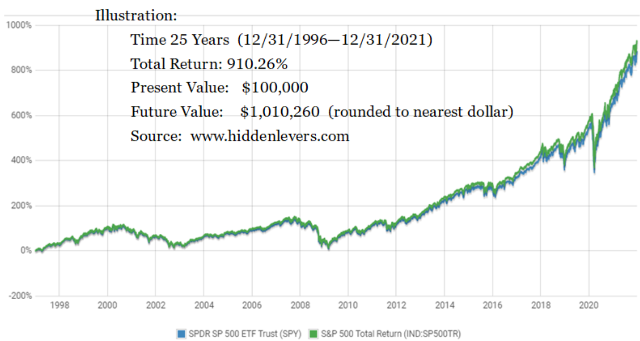
A Roth IRA conversion transfers or ‘converts’ monies from a traditional tax-deferred IRA or qualified plan like a 401(k) to a Roth after-tax account. The participant must add the amount converted to their taxable income. The benefit comes from paying fewer taxes on assets when they have current depressed values. Then following Roth rules, if the participant has had the Roth for over five years, and reached age 59 ½, the growth becomes distributed exempt from federal income taxation.

In this hypothetical example of an ideal Roth conversion, the investor has an all equity, stock portfolio with a market value of $100,000.

Caution: The use of an All Equity (stock) portfolio is for illustration purposes only. Pure Equity portfolios are not generally recommended and should be considered only for the high risk tolerant / speculative investor.

During a 20% correction, when the market price of assets are depressed, the same number of shares can be moved over to the Roth, with only $80,000 added to their income for the tax year.





Roth conversions work best when there is a longer time horizon, and assets converted do not bring the investor to a higher tax bracket. Please consult with your financial and tax advisors when considering a Roth conversion.

Proper planning is essential in thriving in financial storms and those caused by mother nature.

If your plan is sound, then you are prepared for when the storms come.

Some of the concepts that were covered include keeping the proper perspective, ideas in considering the right amount of money to keep in an emergency fund, seeking help when considering tax loss harvesting, portfolio rebalancing, or Roth conversions.

Keep perspective, cut the noise, keep the faith

Matthew 6:34: “Therefore do not worry about tomorrow, for tomorrow will worry about itself. Each day has enough trouble of its own.”

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References:

(1) First Trust Advisors L.P. Data from 2009 - 3/31/2022. *Average is from 2009-2021

(2) Morningstar (2022). Morningstar Investor workstation. https://investor.morningstar.com/chart/timeseries?securities=0P00001G7J&grid=single&duration=max&scale=linear&type=price**

(3) Murray, N. (2008). *Behavioral Investment Counseling*. Nick Murray.

*Specified Time Period

MIKE HECKMAN, MS, CFP®, CEPA®, BFA®, CDFA®, AWMA®, CRPS®, CRPC® is a nationally featured Financial Educator, Author, Speaker, Retirement Planner, and Wealth Advisor. In 2019, Mike founded Sable Point Wealth Management, serving Western Michigan with offices in Ludington and Spring Lake. Mike is currently conducting dissertation research on

wealth preservation strategies in retirement to complete his Financial Management Doctorate from California Southern University. Mike 's completed education includes a Master of Science degree in Financial Planning from Kaplan University's College for Financial Planning and has been a CERTIFIED FINANCIAL PLANNER™ practitioner since 2014.