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LINNARD FINANCIAL MANAGEMENT & PLANNING, INC.

Registered Investment Advisor, Wealth Management & Financial Planning

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Outlook & Trends

One of the interesting, and perhaps maddening, things about studying the economy and the financial markets is that changes are based on the result of disparate decisions and interests of many unknown individuals and groups across the world. How these forces play out is unknowable at any given time, which is why well-meaning commentators and predictors are so often wrong. Today is one of those times when the invisible forces continue to create unexpected effects in the visible sphere.

The Economy

Are you confident in the economy? If your views reflect those of the group polled by the Conference Board this month, you are. Consumer confidence is surging. It has risen nearly 35 points in the five months since the election, as much as the gain recognized during the prior 4 to 6 years. It is higher than any time since the period of “irrational exuberance” witnessed during the dot-com bubble in 2000. It is not because of sudden employment growth. That has stayed steady at a 1.6% percent rate. Home prices are improving at a 5.9% annual pace, which is good for homeowners, but it is not a sudden surge. It is not because consumers are overjoyed about lower interest rates enabling them to buy more. The Fed is raising rates. Nor is it likely that the increase of inflation up to 2.9% for the first time since 2011 has engendered celebrations.

It could be because of GDP growth improved to 3.5% during the last quarter. It could also be because the average consumer believes that the new administration's plans to restore growth and jobs in the economy will work out, despite the continued dysfunction in Washington.

The Markets

The stock market is driven by emotion as much or more than reason. Stock prices and consumer confidence are well correlated. When one goes up or down, the other does too. The stock market has advanced strongly since the beginning of the year, just like consumer confidence. The opinion spinners are suggesting that the rise was powered by campaign promises to reduce corporate taxes, repatriate overseas money, and spend on infrastructure and defense. These are the same pundits that predicted a market crash upon Trump’s election.

Far be it from us to defend the opinions of the journalists, but in this case they just may be right. It may just be a question of timing. Today’s real-time psychology expects long-term results today, if not sooner. It may be that market players are valuing long-term expectations today. The question is what will happen if the proposed policies are not implemented for a while, if at all. It takes time to build infrastructure. It is reasonable to question whether Washington will ever get its act together sufficiently to reform taxes or health insurance.

Consumer confidence reaches peaks that generally coincide with economic and market tops. High confidence also typically accompanies high market value. Unfortunately, high market value corresponds to extended risk and low future returns. It is not knowable when the growth in confidence will ebb or the market will reverse, but it will at some point. After a confidence peak, it is not unusual to see an economic contraction lasting a year or more. Edson Gould, a market technician during the middle of last century, proposed the "Three Steps and a Stumble Rule", which warned that, after the Fed raises rates three times, the stock market will suffer a substantial setback. The Fed just raised rates for the third time. That fact does not imply immediate danger, but already excessive valuation risk will continue to rise right along with any further extension of market prices. It may be fortunate over the near future that the market returns in the second quarter in a presidential term have historically been the 4th highest of the 16 quarters. The moral to this story is, if you are an investor, enjoy the current upward trend while it continues, but make sure you know your risk limits and are prepared for what is likely to follow sooner or later.

Active, Passive, Indexes and Portfolios

The financial industry has come a long way since the high-commisssion, stock-picking days that dominated investment practice through the late 1900's. The Vanguard Group led the way by introducing and popularizing low-cost, passively managed mutual funds. The movement accelerated with the introduction of even lower cost index ETFs, which reduced management fees to almost nothing in some cases.

Index funds, whether of the open-end or exchange traded variety, are designed to mimick an index, like the Dow Jones Industrial Average. The holdings are changed infrequently, so the funds are "passively" managed. This is a departure from the old-line "actively" managed stock (or bond) funds, which spend much effort on research and attempt choose their holdings in order to outperform the indexes. Certain funds may be able to accomplish this feat with consistency, but it has not been possible in the aggregate. Since active funds held the majority of the industry's money, as a group their returns (before expenses) were essentially the same as the index. But then management costs were subtracted, reducing their returns below the index, so low-cost passive funds out-performed.

You may have read advice that passive index funds are the way to go. With the increasing popularity of exchange traded funds and distributors like Vanguard, the benefits of low-cost passive investment vehicles are becoming common knowledge. The difference in the cost of active and passive funds may be 1% or more a year. Last year passive stock funds gained $237 billion in assets while even more ($264B) was pulled out of active funds.

Less well known is that the terms "active and passive funds" only refer to how the fund's holdings are chosen -- either by research or by inclusion in an index. It has little bearing on how your overall portfolio or personal risk exposure is managed. That too can be passive, following a typical "buy-and-hold" or periodic rebalancing strategy. It can also be active, following a strategy that makes tactical adjustments based on economic and market conditions to reduce risk. A passive strategy sets risk exposure by defining the asset allocation in advance, to prescribe the proportion and concentration of risky assets and bonds, according to personal financial goals. This type of strategy is like setting a car's cruise control to a constant speed, which can be very unsettling when the road gets bumpy.

On the other hand, an active portfolio strategy is like driving using the accelerator and the brakes, adjusting for road conditions as they appear. Driving this way takes much greater awareness and effort, but should provide a more comfortable and safer ride under a variety of conditions. The passive strategy was the only reasonable approach when high cost commissions were the norm, but just as low-cost passive funds have reduced the inherent cost of investments, low commissions have enabled the adoption of greater use of tactical portfolio managememt for investors who would like to better control their risk.

By way of disclosure, please note that *LFM&P* offers both investment management strategies, since the appropriate approach very much depends on the individual client and their financial position. In general, we believe that young investors accumulating funds may fit the passive management strategy best. Older, retired or soon to be retired investors, can often be best served by the tactical approach. This allows them to participate in gains, but also have a mechanism to preserve asset value, especially at times like today when markets continue to be overvalued, but the eventual peak is impossible to predict.

If you would like help looking into your financial future, evaluating your risks, managing your investments, or planning to manage your income effectively, please call or e-mail. We invite you to visit our website.

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