Key Questions

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What Do Investors Need to Know When Historical Patterns Change?

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The Key Wealth Institute is a team of highly experienced professionals from across wealth management, dedicated to delivering commentary and financial advice. From strategies to manage your wealth to the latest political and industry news, the Key Wealth Institute provides proactive insights to help grow your wealth.

A first principle of investing that has held sway for a generation may be rendered obsolete. If so, additional investment tools may be needed.

In his 2020 bestseller "The Psychology of Money," investor and author Morgan Housel exposes a fundamental yet seldom discussed truth of investing: "How you behave is more important than what you know."

Unlike virtually every other profession, skillful investing depends less on the books you read, the degrees you earned and the people you know, Housel argues. Success is determined more by the actions you take (or choose not to take), the emotions and biases that inform your thinking and the behaviors you exhibit.

Simply put, the right kind of experiences, such as self-discipline, patience and preparation, matter the most.

Your History Influences Risk Behavior

How people behave is a highly personalized pursuit. In a 2007 study, economists Ulrike Malmendier and Stefan Nagel observed that investors who came of age during the Great Depression were hesitant to take risks.

By comparison, those who were born in the 1970s and saw the S&P 500 Index appreciate tenfold during their teens and early 20s were far more enthusiastic about stocks than other generations. "Our findings suggest that individual investors' willingness to bear risk depends on their personal history," these economists concluded.

Housel attempts to quantify this finding, noting, "Your personal experiences with money make up maybe 0.00000001% of what's happened in the world, but maybe 80% of how you think the world works."

Be Prepared When Correlations Change

So when investing, it is important to understand a large span of history to understand how the world works versus extrapolating the recent past and assuming it will continue. We also must be on alert for potential market changes negating longstanding relationships.

The history of the relationship between stocks and bonds is a good example. Until the middle of last year, the past 20 years were defined by low and relatively stable inflation. During those two decades, inflation averaged 1.7%, with a narrow range of 0.6% to 2.7%. In the previous 40 years, however, inflation was higher and much more volatile, averaging 3.9% while ranging between 1% to over 10%.

This perspective is significant because in the past 20 years, bond prices and stock prices were inversely (or negatively) correlated. In periods when stocks fell, bond prices often rose, cushioning the decline in stock prices. This hedge convinced numerous investors that a portfolio of stocks and bonds would perform well in almost any environment. Over the past 20 years, that was largely true.

But in the four preceding decades, which were marked by high and unstable inflation, stock prices and bond prices had a positive correlation: When stocks fell, bond prices often fell, too, providing little diversification to investors.

This year, based on recent performance, the market conditions of the past 20 years may be nearing an end. As of April 22, stocks are down 10% so far, as measured by the S&P 500 Index. In the same time period, bond prices are also down 10%, according to the Bloomberg US Aggregate Bond Index.

Will this trend continue? No one knows, but much will depend on the future path of inflation. Recent data points indicate inflation may be peaking, although, in our view, it is likely to remain elevated for the next several months, possibly even quarters.

Key Takeaways

We believe investors should consider leveraging additional tools to enhance the diversification of their portfolios and improve their odds of achieving their financial goals. Such tools consist of low-volatility alternative strategies, private real estate and real assets, among others.

Moreover, we recently suggested that clients modestly de-risk their portfolios to incorporate these new tools, where appropriate, given the uncertain outlook for inflation and actions being contemplated by the Federal Reserve (the Fed) to restore price stability.

The US economy is strong, so the risk of a recession is low. But with the Fed beginning to tighten monetary conditions, the odds of a financial accident are high. Should the odds of recession increase, we would suggest an even more defensive stance as recessions tend to result in longer and deeper drawdowns, or stock market declines. Financial accidents, on the other hand, are usually shorter-term growth scares. They are also less acute and typically turn out to be buying opportunities.

Neither a recession nor a growth scare feels particularly good at the time, although it is important to be prepared. Consult your advisor to review or develop your long-term, strategic asset-allocation strategy – a long-term plan designed to help minimize emotion and chart the course ahead through the ups and downs of the market. Adaptability is important, but for the plan to work, it must be maintained above all else.

For more information, please contact your advisor.

About the Author

As Chief Investment Officer, George Mateyo is responsible for establishing sound investment strategies for private and institutional clients, expanding internal and external research capabilities, and managing the delivery of solid risk-adjusted investment performance.

In previous roles, George spent more than 15 years in investment management and investment consulting, where he acquired firsthand knowledge and insights into the capital markets and the stewardship of investment portfolios for institutional and high net-worth investors.

George received his MBA from the Weatherhead School of Management at Case Western Reserve University and completed additional studies at the London School of Economics.

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