War, Conflict & Long-term Investing

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Keith: Welcome to the Empowered Investor. My name is Keith Matthews and I'm joined by my co-host Marcelo Taboada for today's episode.

Marcelo: How are you, Keith?

Keith: I'm great. I'm super excited about this episode. I think it's super timely and our clients and listeners will appreciate it.

Keith: Yeah, it's a tough one. We're dealing with the geopolitical events of the Ukraine war and the implications for investors. But I have got to tell you, for me, it's one of the harder ones to think about primarily because of all of the injustices and the difficulties that individuals and humans have to go through. It's tough, but we do have to cover it. We do have to review it. What are your thoughts on the subject matter?

Marcelo: It's obviously very painful to watch all the people being displaced and the Ukrainian families. We have a person with family in Ukraine here in the firm, so it's hitting close to home for us. I think it's a humanitarian tragedy and I'm expecting to see how this will all play out. But I was talking to a client the other day, and we agreed that if your one concern is your portfolio, you're extremely blessed. Not that this person doesn't feel like he's blessed, but the fact that we're here in Canada, in a democratic country, and we can worry about things like our portfolios means that we're extremely blessed, and we should be thankful for that.

Keith: Absolutely. In today's show, Marcelo, we're going to review a few things. We will review the implications on portfolios. We will review the concept that we often hear of "this time it's different" and why that concept leads to poor decision-making for investors. We'll review the evidence behind previous geopolitical events and crises and wars, and we'll learn from those. Finally, we'll discuss what investors should do—the plans, the thinking, the strategies that one should use as we deal with these more volatile times. So, Marcelo, let's get to the crux of things. Why are we doing a show like this at this particular time?

Marcelo: If we're here talking about it, Keith, it's because it's creating anxiety, and obviously markets are very volatile. So we have to discuss it, and we have to address it. Clients look to us to address this type of thing. I think it's something that needs to be discussed.

Keith: Yeah. We sent out an earlier client note by email, and it was well received. But essentially, individuals at this particular time have heightened anxiety and have concerns. Unfortunately, these are not new events. And if you look back in the last 30, 40, 50 years, while this may feel different, there's always issues that we have to get through. Geopolitical risk is part of investing. We've been dealing with this for a long time, and we need to address how to get through these moments.

Marcelo: Yeah. We also tend to forget that warfare and war are ingrained in our history, and it's almost what made us. A lot of the times, to have peace, you have to go through periods of human conflict, which is really unfortunate, but it's just part of who we are.

Keith: So we talked about this before the show, and we were trying to figure out what the number one challenge is for most investors. And we came up with a theme that we'd like to discuss. What's the theme, Marcelo? What do we think is the number one challenge for investors right now?

Marcelo: I think you alluded to that in the intro, Keith, and I think you hit it on the spot because it's this idea that when we have a geopolitical event or a war or a recession or a new technological development, it's this flawed thinking that this time will be different. And we've never seen something like this before, and this creates this urge to do something different or act differently. But in reality, we've seen this before, like you said.

Keith: Yeah. We haven't necessarily seen this before.

Marcelo: Correct, correct.

Keith: But we've seen the concept of new events unfold and how that plays through in terms of diversified portfolios and what it looks like six months, a year later, two years later. We've been in this business for a long time. There are many situations that I've seen in the past where individuals will come to us and say, "I have never seen this before. This time it's different. Should we do something? Should we adjust? Because this time it's different." And it doesn't have to necessarily be a war. It could be—I'll just list a few things where I used to hear this from investors. In 2001, when we had the terrorist attacks in New York City, I remember that vividly. I was a young advisor, and we were watching on TV the two planes being flown into the trade centers. And of course, the reaction is, "This time is different. We've never seen this before." Obviously, we hadn't.

Marcelo: Yeah. Like we had seen terrorist attacks, but we never had seen two planes fly into buildings.

Keith: Yeah. And in 2008, this is not necessarily a geopolitical event. It was more of an economic crisis, the housing crisis. Individuals would have said things like, "I've never seen investment banks the size of the ones that we saw in New York go under." And so whether it's Lehman Brothers, Merrill Lynch, AIG, people were saying things like, "I've never seen this before. This time is different."

Marcelo: I think nobody expected either the complete collapse of the housing market in the U.S. There's always this idea that real estate never goes down. We hear that often these days. So yeah, back in the day, it was like we've never seen that of that scale.

Keith: And ultimately, this "time it's different" concept, I think, is a dangerous concept for investors to anchor to because what it does is it almost encourages them to change their plans, to adjust something. And we saw it two years ago, Marcelo, again with the pandemic. We'd never seen that before. That scale where all of a sudden, economies and societies are being shut down, and people are being asked to wear masks and you have a lockdown. And it was clear that people could look around and say, "I've never seen this before." And so here we are today with a Russian invasion of Ukraine, which we've seen countries invade other countries, but not to this scale, not to this size. And last week, when Russia says, "We'll put the nuclear arms on alert," people would say, "I haven't seen that before." And so therefore, should I be thinking differently? What should we do? This is the crux of the issue. Often, when we see these geopolitical events, it's the worry about "I've never seen this before" and it stirs emotions. And those emotions can make investors ultimately do the wrong thing, which is change portfolio structures to the extent where they'll regret it in a year or two from now.

Marcelo: Yeah. And what makes it worse now is—and we've alluded to this before, Keith—is the constant bombardment we have. We've always had the news, but now we have social media, and people are constantly connected to it, to the conflict, which is a good thing because a lot of the things get exposed, and people get more access to information easily. But psychologically, it's a tough thing to go through, right? When you're going through the constant negative news all the time, it can build into the narrative that this time is different.

Keith: A hundred percent. Marcelo, we're going to review patterns here. We have a list of—and we're not going to go through the list—but we have 25 geopolitical events that have occurred really going back since the start of World War II. So whether it's the attack on Pearl Harbor, whether it's issues that appeared in the 1950s, the North Korean invasion of South Korea, various different terrorist attacks, various presidential assassinations. We have a list of 25 geopolitical events. And these are not recessions, because we're going to make that distinction later in the show that we're talking about geopolitical events here. So what are the general patterns in terms of the way stocks tend to react either before, during, or after?

Marcelo: It's an excellent question. And I think the first thing that happens is markets, for the most part, get agitated prior to the conflict. There's a lot of buildup and expectation as to what is going to happen. And as we know, the market is a forward-looking machine, right? So it's processing all this information in real-time. So I think in anticipation, they do get agitated, and we do see volatility. Then, at the time that it happens, so at time zero of the conflict, the markets are often at the lowest. So that's where you see the big dip. And what happens is that when you look at the data that we have, it's three or four months after when the stock market or the equities are back to the pre-crisis level. So we see this big volatility, big dip, and then three, four months after, we're back in black, so to speak, into the levels that we were before when the crisis started. So that's the pattern that we see in the data. Like you said, we have about 25 different conflicts here. So only four out of those

25 events took longer than two months to recover, and only four of the events had a correction of 10% or more. So in hindsight, you can say that these events presented themselves as a big buying opportunity, even though we don't do market timing. You do see the pattern in when these conflicts erupt. Of course, it's hard to shun the emotions when you're going through these big drawdowns or big periods of dip.

Keith: Yeah. Looking at the chart right now, it's pretty clear that there's a drawdown, and we've got the largest drawdown being the attack on Pearl Harbor in 1941 at 20%. The rest are coming in the mid-teens, maybe 10, maybe five, four, lots in the ones and the twos. But the flip side is the recoveries tend to all happen within, as you mentioned, two months. Those are geopolitical events. And I think it's important that we make a major distinction between a geopolitical event and a recession. If I look at these numbers right now, for a geopolitical event, from an investment perspective, it seems to be a shock. It seems to be discomfort. It seems to be something we don't want to go through. The flip side is it doesn't seem to last very long, and it doesn't seem to be as deep as a recession. Now, a recession is something totally different. And that's where you've got an economy that's shrinking. And that has more severe implications on portfolios than the geopolitical events.

Marcelo: Yeah, a hundred percent. It's just a different animal altogether.

Keith: Yeah, it's not unusual for us to see recessions where stocks are down 20, 30, 40%, maybe even more. Now, they don't stay down forever, but they might go down to that extent. But that's not what we're talking about today.

Marcelo: What do you remember from all your years of being an advisor, like in previous conflicts? How did your clients react? Anything that we should highlight here?

Keith: You know what? I will say with our existing clients right now, the way we're hearing them and speaking to them, there's almost a sense this time of more worry for what's going on the human side and the tragedies and the stories, and a little less worry on the portfolio front. I vividly remember the planes in New York City. That was just a moment you'll never forget. But the recessions were more difficult. So the 2001 recession and the 2008 recession were more difficult on portfolios and I think on investors. And the pandemic, the first month, that was also a strained time. That period, stock markets went down about 35% in 30 days. Those are shocks. Those are not geopolitical events, though. Today we're in the geopolitical event discussion.

Marcelo: Yeah, what's remarkable too is you've seen the world unite. Look at how divided we became with coronavirus and the whole vaccine discussion. Even in the U.S., we have a lot of polarization that's creeping into Canada now. And now we've seen this complete unity of people agreeing that everybody should ban Russia and businesses are doing that. Companies, they're sanctioned. So I think that's good to see, even though we're going through a very bad humanitarian crisis as well.

Keith: You're absolutely right, Marcelo. Let's switch gears a little bit and talk about portfolio construction and Russian equity exposure. So our clients would have Russian equity exposure because part of our international weighting would have emerging market weighting. But when we go through our portfolios, we've got maybe 0.3 of 1% of Russian exposure inside of international equities. And if international equities are 20% of a total portfolio in a 60/40 portfolio, we'll use as an example. That means across an entire portfolio, we're looking at 20% of 30 basis points. We're talking 0.06 of 1%, which is almost zero but not quite there yet. So what are the implications? What are firms like Dimensional or for those that use exchange-traded funds that invest in emerging markets, whether it's MSCI or FTSE, what are the majority of investment organizations doing right now?

Marcelo: They're completely stopping any trade in Russian equities, and they're all going to be divesting their current holdings and completely removing them from their investment process. So DFA specifically, which is the company who builds our portfolios, they already decreased their exposure to the Russian equities during the Crimean war of 2014. And now they'll be completely removing them from their process, and whatever holdings they have will be divested. And I think MSCI and FTSE, which are companies that build indices and build investment products, have already said that they're going to do the same thing pretty much. They're going to remove them from the index and not list them at all.

Keith: So for our clients, they didn't really have much exposure to Russian equity. And most Canadians don't have that much. What you're seeing is this unanimous basic voting machine of everybody saying enough's enough. We're not going to invest in Russia. We're not doing business in Russia. We're pulling away. It's not a huge economy, but it's still 11th or 12th. I think the implications are perhaps a little bit more on what happens to inflation. And I was reading in the Wall Street Journal this week that keep your eyes on what the Fed does more than what's going on in Ukraine as an indicator of what might happen later in the year.

So how do we learn from this? How do we get through these crises from a portfolio and investor perspective? And what can we learn from past ones for this one and then be ready for future ones?

Marcelo: I think the more you live through them, you become experienced. It's not the same thing to intellectually understand what going through a period like that is, but once you live through a few of them, you tend to be more seasoned. So I'm in a very young career in this industry, right? So I haven't lived through many of them. So for me, this is all new at the same time, but every time we go through a drawdown period, and I guess for a client, it's the same. You get to have a better perspective for the next one. And what's remarkable too is most of our clients haven't called in and expressed concern. And we obviously are being proactive and reaching out to them, and they appreciate that. But I think that says a lot about the way we manage the portfolios, which we do a lot of education and we do a lot of scenarios when we're onboarding them and all through the years to show them what could happen in a portfolio when we go through either a recession or a geopolitical event, right?

Keith: Absolutely. And the lifeboat drill that we've been using, and it's part of our investment policy statement, we call it a lifeboat drill. It's our nickname for it because it's this process. It's mostly tied to recessions, not geopolitical events, but in the last six, seven major recessions, this is what stocks have done. This is what your type of portfolio has done. This is how long it took to get to the bottom. This is the drawdown, the depth of the correction in your portfolio. And this is how many months it took to get back. That's probably the most useful call it drill, exercise, explanation that we've been able to provide our client because I think they're better prepared.

Marcelo: We always tell clients too when we onboard them that if you see the market going down, go back and look at it. Then we always make a point to review them with them when we have their review and we're meeting with them just to make sure that they know that these things could happen. And we also set the expectations when we go into our portfolio. So now is not the time to be changing your bonds and stocks allocation. You do that before, and you coach the client through what could happen during periods of volatility. So having a plan is very important.

Keith: Absolutely. Let's start coming up with our recommendations, Marcelo. Obviously, it's fine and dandy to tell people don't worry, stay the course. But at the end of the day, we're all human beings. We all have emotions. We all see things. We all see tragedies. It can't help but stir an individual to think about wanting to do something. But we know that staying the course is the best way to do things. Let's talk about the ability to bear risk. So when we look at portfolios and investors, there are two things we always, as professionals, need to review. Capacity to bear risk, so their financial capacity, their value of their net worth, their value of their earnings. How much can they risk based on their financial strength? The second one is their ability to bear risk, their emotional ability to bear risk. So talk about that one a little bit, Marcelo.

Marcelo: I think that's a very important one because the capacity and the ability are completely different. And money is very primal. It really touches a nerve in human beings because it provides safety, provides the ability to provide food for a family or provide education to your children. So we understand that even if you have the ability to take the risk, the capacity may be something different because these events are scary. And even if it doesn't affect you in a way that you're worried about the portfolio, it may affect you emotionally, it may affect you in other areas of your life. And we have to acknowledge that, right? And we have to coach the clients through this type of environment.

Keith: Absolutely. And so it's our responsibility or the investor's responsibility to truly understand how they deal with risk. So if they cannot live with a portfolio being down by a certain amount, they just simply should not and they cannot own certain weightings in stocks. There's almost no ifs, ands, or buts about that. If they cannot deal with that, and if their emotions will not let them go there, then they have to be very careful in terms of the weighting of stocks they have in a portfolio. Really then, individuals have to develop an investment plan that they're comfortable with and that they can live with. And that means different things to either accumulators or retirees. I always say that if you're an accumulator, so you're 30, 40, 50, you're accumulating wealth for the future. You almost wish for markets to be low. You wish for volatility, you wish for bear markets, you wish for difficulties so that you can buy stocks at lower levels with higher expected returns. For retirees, it's a bit different. You have to make sure that you have enough money that can cover short, medium, long-term requirements and that you have a sustainable lifestyle that will last decades. What about investment philosophy, Marcelo? How important is that inside the investment plan?

Marcelo: Oh, it's huge, right? Because it's your guardrails. That's what we were saying before. It's not only necessary to have a plan. The plan is fine and dandy, but how are you going to carry yourself through this period is what the investment philosophy provides you with. It gives you the guidelines and the guardrails to navigate these periods, right? So the investment philosophy—it's the example we've used many times in the past, right? It's the siren songs. It's like you not giving into the siren songs when you want to give in to the emotions. It's like the investment philosophy is what carries you through that.

Keith: Absolutely. A hundred percent. It's the do's and don'ts. What do you do and what do you don't do as you think about managing your portfolio or the advisory firm thinks about it? So in our world, for example, we never tell people that we can predict the future. We can't. Nobody can predict the future. But the good news is you can still build an incredible investment plan without being able to predict the future. So that philosophy is critical, and it's part of the investment plan. Marcelo, I'm going to ask you a question here. Obviously, you're going to tell me that these investment plans need to be built in advance of a storm. So we often see geopolitical events, crises, wars, economic events, natural disasters, and then most recently, we can now include health challenges, the pandemic. So how do you get your portfolio ready for these storms?

Marcelo: Like I said before, you never do any changes or any major switches when you're going through this type of crisis. The moment to do that is when there's no storm. You set up an asset allocation, like you said, you coach the client through the ability and the capacity to take risk. And then you decide on an asset allocation, and then you stick to it. So it takes a lot of education and setting up the proper expectations and setting up the proper investment philosophy. So when those moments do come in, you have your guidelines and your guardrails. Sometimes people think we don't do anything when bad things happen, but it's the worst time to do it.

Keith: Absolutely. You never ever make changes in the middle. You always have to set your portfolio, like you said, Marcelo, in advance. So when you talk about a long-term portfolio that has to be able to weather multiple events throughout. So you're a hundred percent right.

Marcelo: I would even go as far as if a client were to come to us and say, "You know what? I want to change my asset allocation because I can't deal with the volatility," I would urge them to say, "Let's wait until the storm passes and then reevaluate your asset allocation and then go through the expectations." Because again, we may onboard someone or be dealing with somebody who hasn't lived through this period. And they may be able to intellectually comprehend what going through a recession or a geopolitical event is, but the reality is that living through it may be a different experience than thinking about it.

Keith: Yeah, absolutely. So Marcelo, we're going to wrap up. I'd like to get a few takeaways from you. I know that we're dealing with a difficult subject. We opened up by talking about how painful this is on Ukraine, how difficult it is on the Ukrainian people. And we are all very empathetic and sympathetic to what's going on. How do we conclude? What are our takeaways?

Marcelo: My takeaway is we understand that people will be emotional. We understand that it is an unfortunate situation for the world to be living in. But in terms of your portfolio, we have seen this before. It will pass, and we have an investment philosophy for a reason, and we just got to stick to it. That's my takeaway.

Keith: Excellent. I think that's a perfect takeaway for all our listeners, and we're going to end with that takeaway, Marcelo. So folks, thank you so much for tuning in to the Empowered Investor. Stay well, and we will see you at the next episode.

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