Westshore Wealth *Insights*

Thoughts on Coronavirus and Market Volatility

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WESTSHORE WEALTH

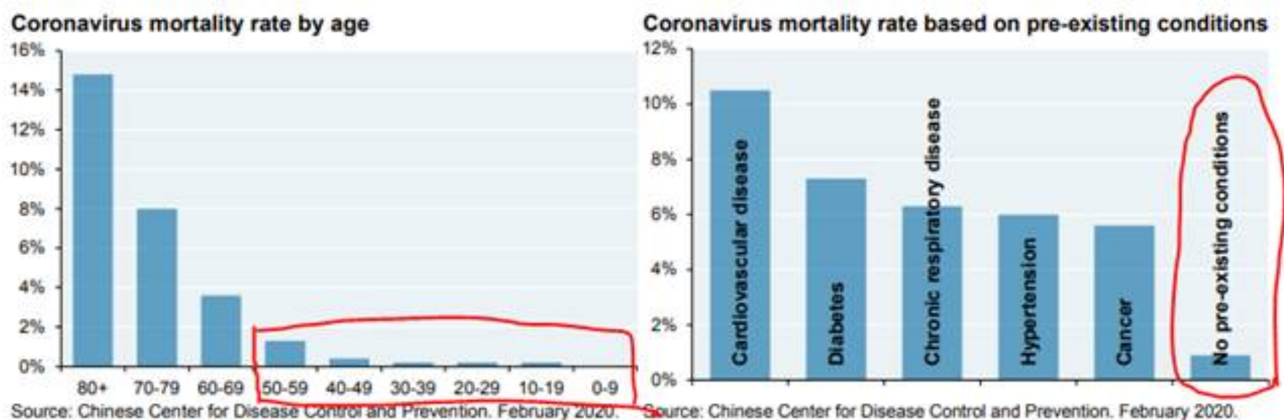
Thoughts on Coronavirus and Market Volatility

US equities suffered a significant selloff last week, in fact the fastest pullback of 10% or more (commonly defined as a correction) in stock market history. The forward P/E multiple of the S&P 500 contracted from a historically expensive 19x, to a more reasonable 16.7x, in a period of six trading sessions. Fear measures that we watch soared to levels not seen since the 2007-08 Credit Crisis. That extreme risk aversion led investor to flock to safe havens with the 10 year and 30 year US Treasury Bonds yields falling to all-time lows. At this point, what are investors to do?

Unfortunately, it's becoming obvious that the novel coronavirus, COVID-19, is going to turn into a pandemic. The problem for containment is the long incubation period and the fact that you can transmit the virus while being asymptomatic. There is little way to stop it if you don't know who has it. While the economic impact will likely be substantial, here is why we shouldn't be in a panic. The bottom line is that the disease isn't that deadly (see illustrations below). I know this flies in the face of the sensationalism that you are seeing on television, but mortality rates are running roughly 1%. This may seem like a lot, but remember this captures only the patients who have actually been diagnosed. For context, the vast majority of people who contracted the virus on the Diamond Princess ship had no idea they were ill. It is highly probable that the incidence of the virus goes well beyond those who have officially been counted, and thus, the stats that we are seeing on mortality greatly overestimate its virulence.

Additionally, the people who are vulnerable to the disease are exactly the same as the common flu, namely those with pre-existing health conditions and the elderly. This isn't meant to minimize the human tragedy, but keep in mind that in the 2017-2018 flu season, the United States experienced 80,000 deaths related to influenza. For COVID-19 to turn into something similar, it would have to infect millions of people here domestically.

On the good news front, as the weather warms, transmission will get more difficult. Look no further than Thailand. That nation saw 3mm+ Chinese citizens visit during the Chinese New Year period and yet it only has 42 cases. Similarly, other geographical areas with high Chinese interaction like India (3 cases), Australia (25 cases), and Malaysia (29 cases) all have small infection rates. What is the commonality? All reside much closer to the equator where temperatures sit between 80-90 degrees. Second, numerous pharmaceutical companies (Gilead, Novavax, Moderna, Sanofi, Glaxo, JNJ, and Regeneron) have sequenced the virus and are either testing existing medications or have started Phase I trials on vaccines. Inevitably, a vaccine or treatment will come our way, likely within 12-18 months. This will be scary, but it will be eradicated and we will turn to the future once again.



The risk for the market is not the disease, it is how people react to it (E.g. not going out to ball games, restaurants, shopping malls, movies, discontinuing travel, etc). If consumer spending is disrupted, it is easy to imagine that the economy sees a shallow recession. What does that mean for the stock market? In a modest recession, S&P earnings could fall 10-15%. For the sake of illustration, let's say S&P 500 EPS fell to something approximating $145. At our current P/E multiple, the market (defined by the S&P 500) would bottom a touch above 2,400. If the P/E multiple were to simultaneously shrink to 14-15x, we could see an outcome that pushes the S&P 500 down to the 2100 area. At Westshore, we think that type of an outcome is unlikely. Why? Keep

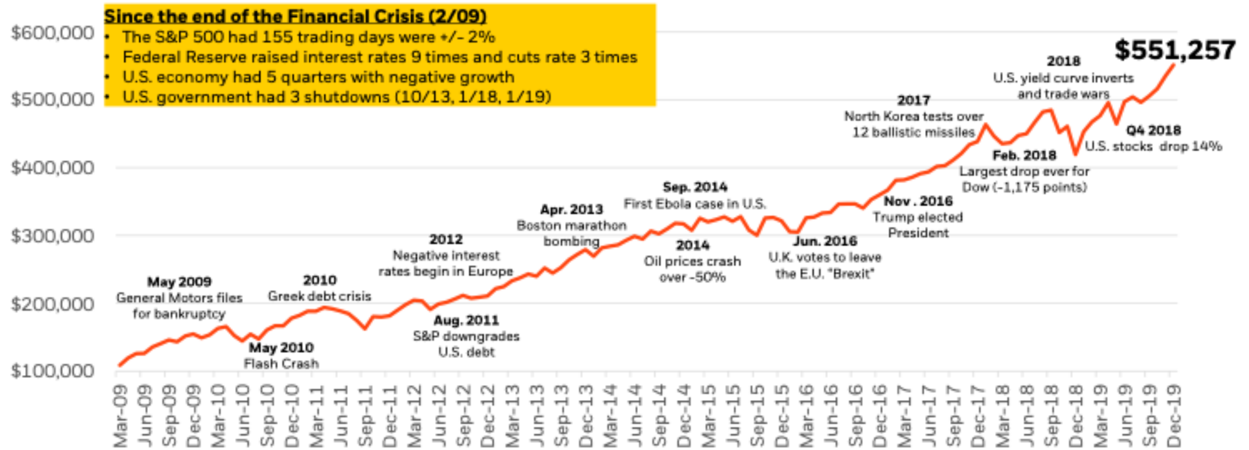
in mind, healthcare scares are transitory. We've had bird flu, SARS, and MERS all within the past 10 years. Each has been controlled within a year's time. Unless, something dramatically changes in the lethality of this disease, eventually a vaccine will be produced and this will cease to be an issue.

Let's continue to build out our consideration set of possible outcomes. For argument sake, let's say 2020 is a write-off because of COVID-19. However, let's also assume that we fix the situation and people start to look forward to normalcy in 2021. Let's assume the S&P 500 sees EPS rebound to growth of 6-7% from the 2019 base year. That would be about $175 of EPS power in 2021. To be conservative, let's apply a forward P/E multiple of 15x, a rather significant discount from present levels. That equates to 2,625 on the S&P 500. While all of this is a gamble, this is the way that we create an educated guess of where we could find a hard bottom. If 2,625 proved accurate, that would be down another 8.5% down from these levels.

So why not sell or short the market? Namely, because no one is smart enough to figure out when to get back in, and additionally, fear measures right now are off the charts (levels only seen 8 times in the past 20 years). Let me show it to you a couple of illustrations. First, there is always a reason to sell the market. See below. Despite that, if you hung tight over the past ten years, you kept compounding your money. Those who sold experienced a massive opportunity cost.

6 There's always a reason to sell stocks...

Growth of $100k in the current U.S. bull market
3/1/09-12/31/19



Source: Morningstar as of 1/31/20. US Stocks represented by S&P 500 2018 and the IA SBBI US Lrg Cap Index 1931 and 1969. **Past performance does not guarantee or indicate future results.** Index performance is for illustrative purposes only. You can not invest directly in the index.

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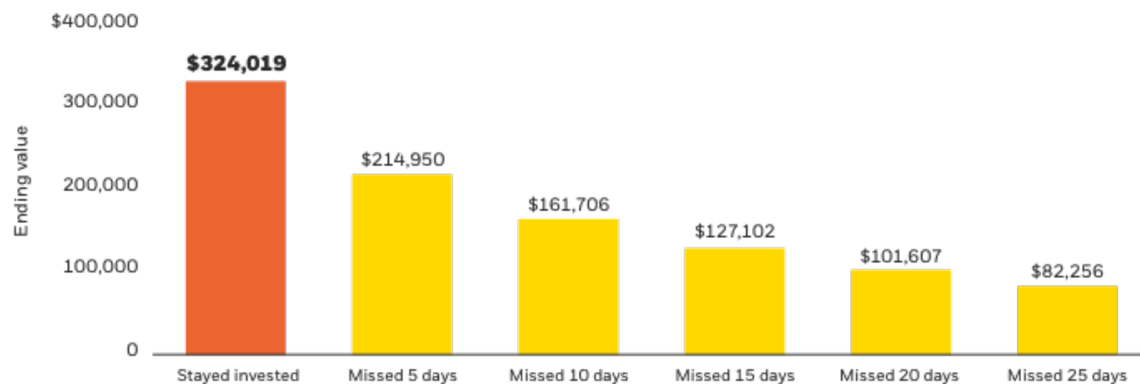
The key is time in the market, not timing the market. See below how important being there for the big up days is to achieving great capital returns over the long haul. If you missed the best ten days of the last 20 years, your halved your returns over a 20 year period. Remember this period includes some very ugly periods (the 2000 bubble collapse as well as the credit crisis of 2007-08 saw the market lose better than 50% of its value). We didn't just cherry-pick a market that was up in a straight line.

Strategies for volatile markets

BlackRock.

The graph below shows how a hypothetical $100,000 investment in stocks would have been affected by missing the market's top-performing days over the 20-year period from January 1, 2000 to December 31, 2019. For example, an individual who remained invested for the entire time period would have accumulated $324,019, while an investor who missed just five of the top-performing days during that period would have accumulated only $214,950.

Stay invested: Missing top-performing days can hurt your return
Hypothetical investment of $100,000 in the S&P 500 index over the last 20 years (2000-2019)



Sources: BlackRock; Bloomberg. Stocks are represented by the S&P 500 Index, an unmanaged index that is generally considered representative of the US stock market. Past performance is no guarantee of future results. It is not possible to invest directly in an index.

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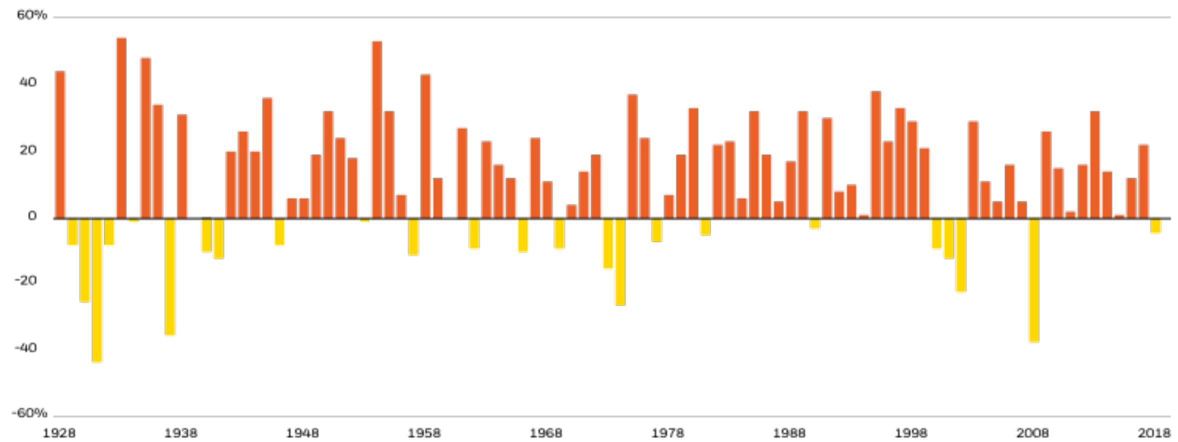
Finally, betting against the market is essentially like betting against the house in Vegas. Odds are clearly on the favor of the upside. These next two slides illustrate that perfectly.

Staying invested for the long-term

BlackRock.

Investors know that it's logical to think long-term when it comes to investing. But when headlines about the market turn worrisome, many feel the need to act. Acting impulsively in the short-term could have significant consequences when it comes to trying to achieve your long-term financial goals.

Over shorter time periods, investing may feel turbulent
1-year returns of stocks (1928-2018)



Sources: Bloomberg; Lipper. Stocks are represented by the S&P 500 Index from 2/1970 to 12/31/18 and the IA SBBI U.S. Lrg Cap Index from 1926 to 2/1970. The S&P 500 Index is an unmanaged index that consists of the common stocks of 500 large capitalization companies, within various industrial sectors, most of which are listed on the New York Stock Exchange. Past performance is no guarantee of future results. The information provided is for illustrative purposes and is not meant to represent the performance of any particular investment. It is not possible to invest directly in an index.

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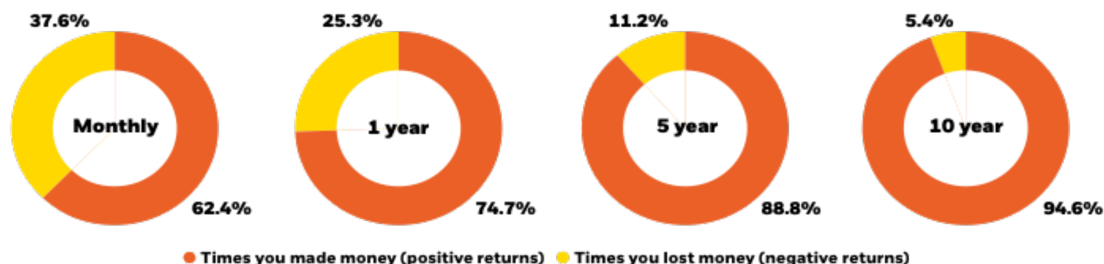
The stock market can be volatile in the short term. It can decline substantially in a single day, creating fear amongst investors. But if you stay calm, you'll find that the likelihood of a positive return grows higher the longer you stay invested.

The longer you stay invested, the greater your likelihood of positive returns
Rolling returns of stocks (1928-2018)



Sources: BlackRock; Bloomberg; Lipper. Stocks are represented by the S&P 500 Index from 2/1970 to 12/31/18 and the IA SBBI US. Lrg Cap Index from 1926 to 2/1970. See front for a description of the S&P 500 Index. Past performance is no guarantee of future results. This is for illustrative purposes only and not indicative of any investment. It is not possible to invest directly in an index.

Want to know more?

blackrock.com

Investing involves risks, including possible loss of principal.

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Bottom line, now is not the time to sell. The key to withstanding shocks is portfolio construction. For some time, we at Westshore, have considered the market expensive and have purposefully constructed portfolios with conservatism. We have taken great pains to put together portfolios that have ballast, in the form of fixed income securities, shock absorbers in the form of option overwriting and other hedges, diversity to spread risk across different securities, and finally uncorrelated assets that tend to move in an asynchronous manner to other part of the portfolio. The grand sum of these measures dampens volatility and allows us to minimize the damage, situating us properly for the rebound. In fact, for those that can, corrections of this type are the perfect time to commit to dollar cost averaging more funds into the market.

Important Disclosures

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